



# **LGIP QUARTERLY MEETING & CONFERENCE CALL**

**5.5.2011**

**OFFICE OF THE ARIZONA STATE TREASURER**



# AGENDA

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- Earnings
- LGIP Performance
- Endowment Performance
- Asset Allocation Changes
- Endowment Distribution Formula
- State Cash Flow
- Arizona Economic Update
- State Budget Presentation: Richard Stavneak, Director Joint Legislative Budget Committee
- Q & A



# INVESTMENT PHILOSOPHY

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**SAFETY**

*before*

**LIQUIDITY**

*before*

**YIELD**



# EARNINGS THRU MARCH 2011

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**\$41,626,178**





# LGIP PERFORMANCE

## 3rd Quarter and FY 2011 YTD



# Pool 5: Overview

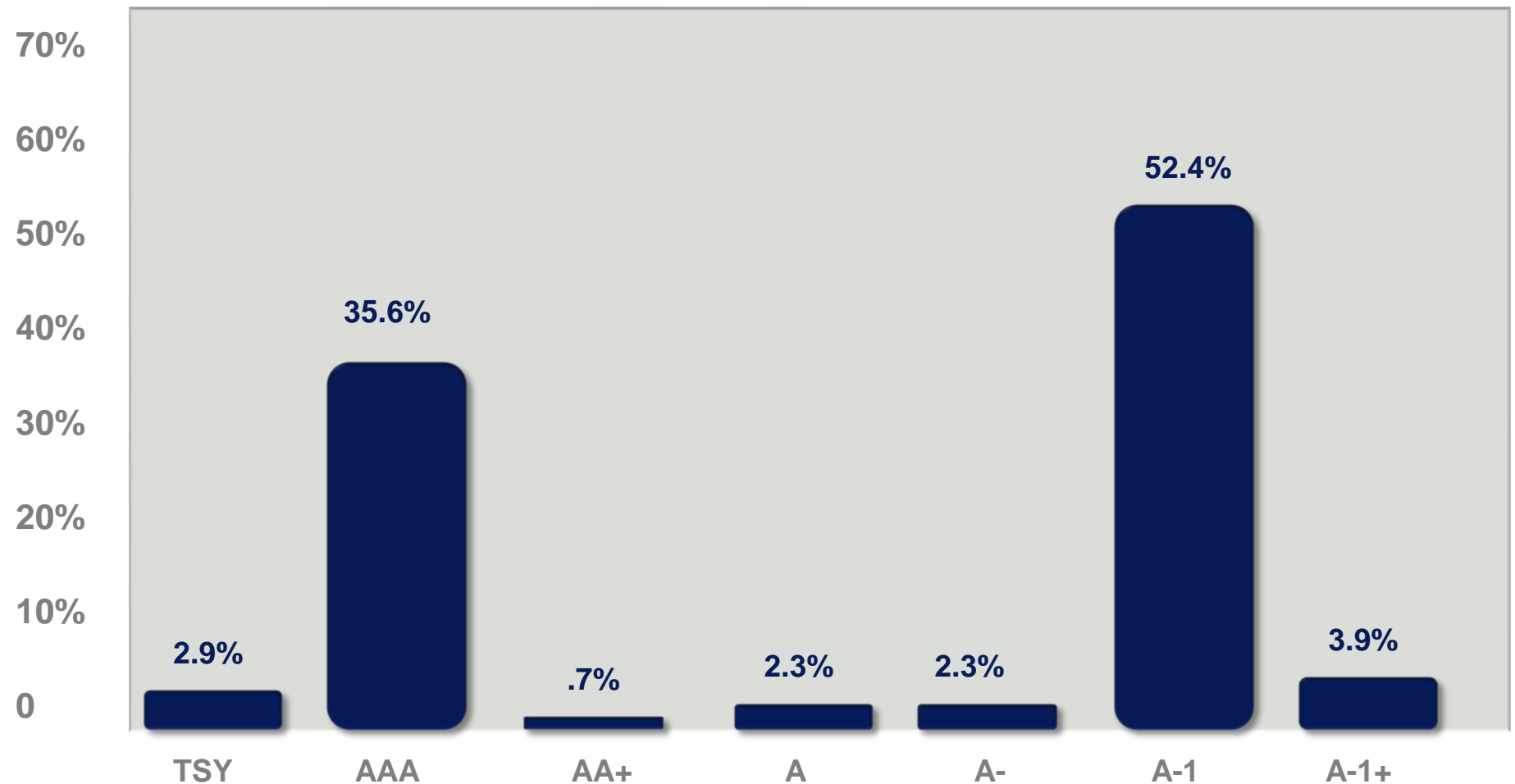
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- **\$1.4 Billion Assets as of 3/31/2011**
- **Net Asset Value - \$ .9998 3/31/2011**
- **Diversified investments weighted to highly rated Commercial Paper first, Repurchase agreements second, and Agency/Treasuries third**
- **Will be extending Weighted Average Maturity slightly but keep under 60 days**
- **Keep daily liquidity in the 10-30% range**
- **Maintain the highest rating possible from S&P**



# Pool 5: Safety

Continues to receive highest rating from Standard & Poor's: AA Af/S1+

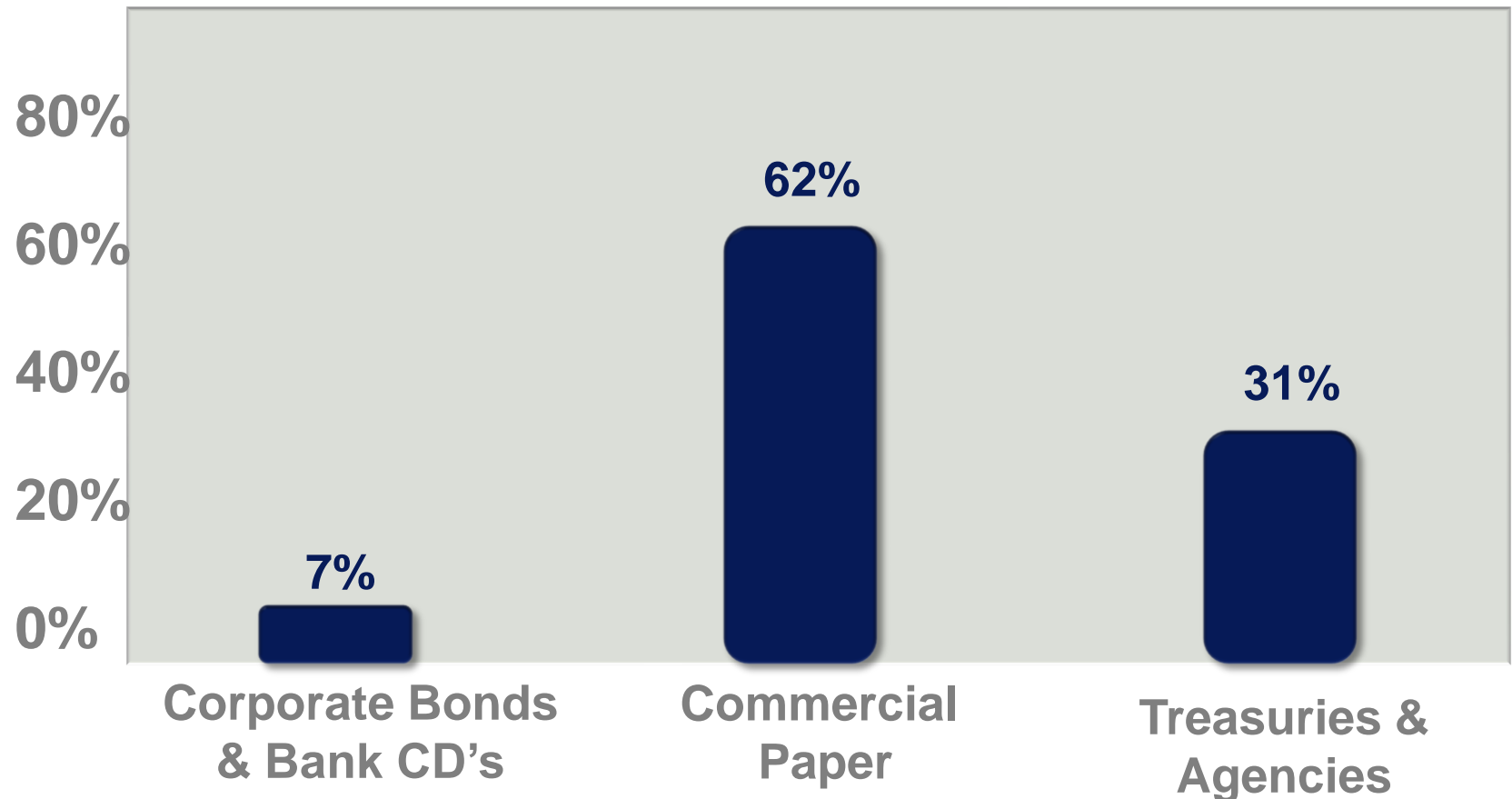


# Pool 5: Liquidity

**Weighted Average Maturity: 39 days on 3/31/2011**

**DURATION:** 100% from 0-1 yrs

**ASSET MIX:**

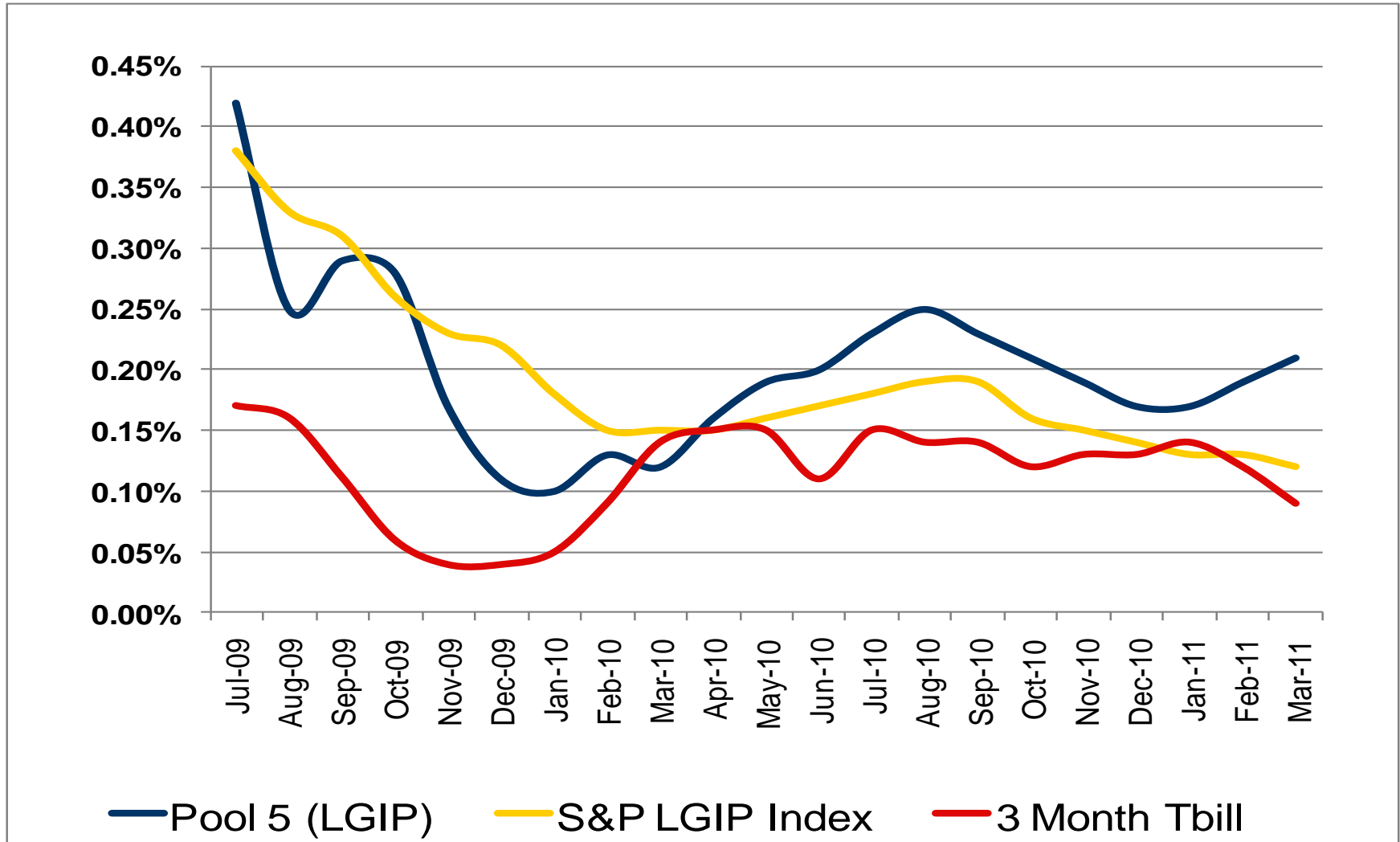




# Pool 5: Yield

**.21% YTD**

**.16% YTD (S&P LGIP Index)**



# Pool 7: Overview

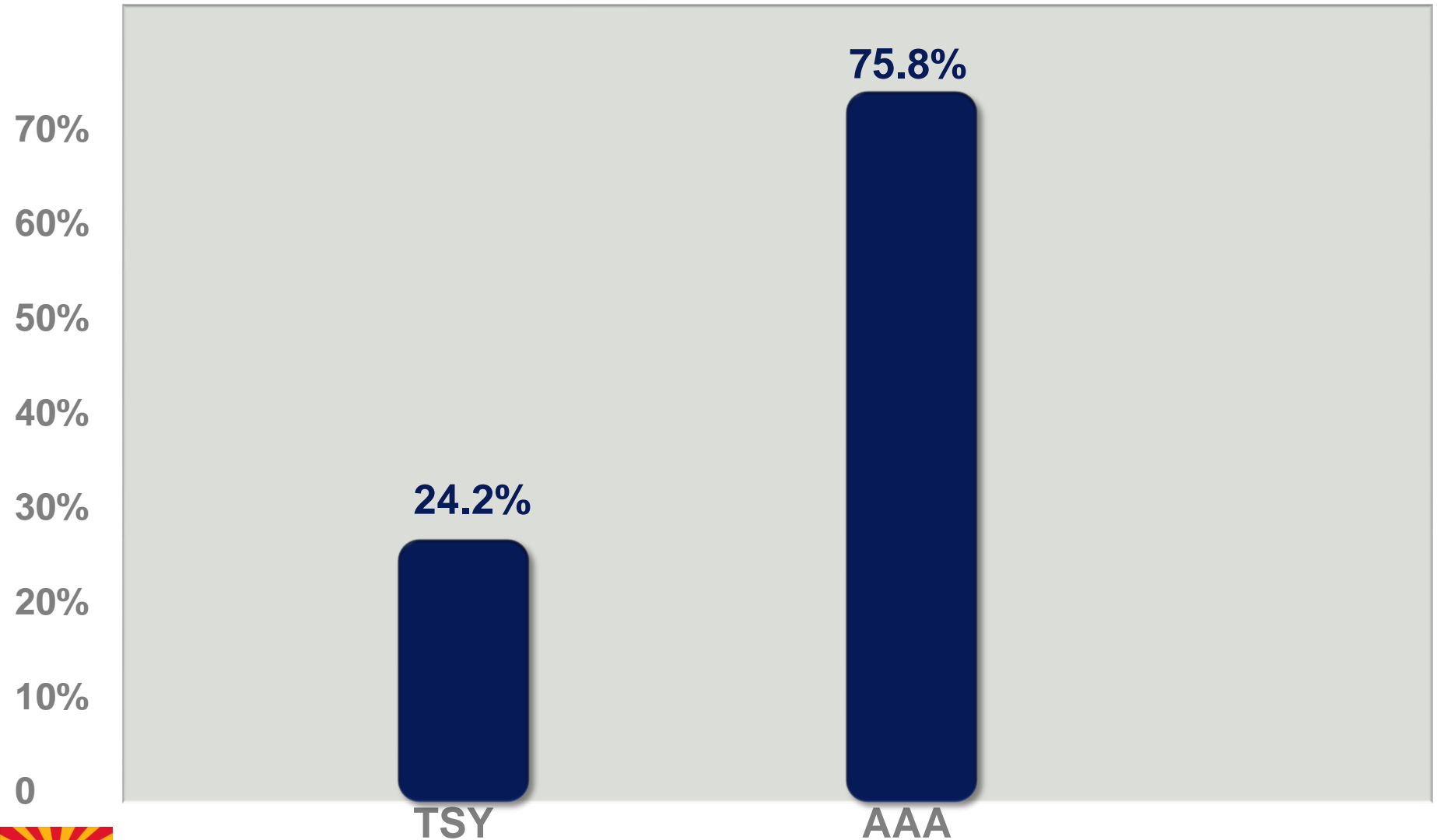
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- **\$1.8 Billion Assets as of 3/31/2011**
- **Net Asset Value - \$ 1.000 3/31/2011**
- **Disruptions in the repo market begin April 1, 2011. As a result, yields have declined and we have shifted to holding less overnight repo and laddering out repo purchases along a three to five week time span**
- **Will also ladder treasuries and other full faith and credit products up to 13 month horizon**
- **WAM will increase but stay under 90 days.**



# Pool 7: Safety

## AAA Weighted Average Rating

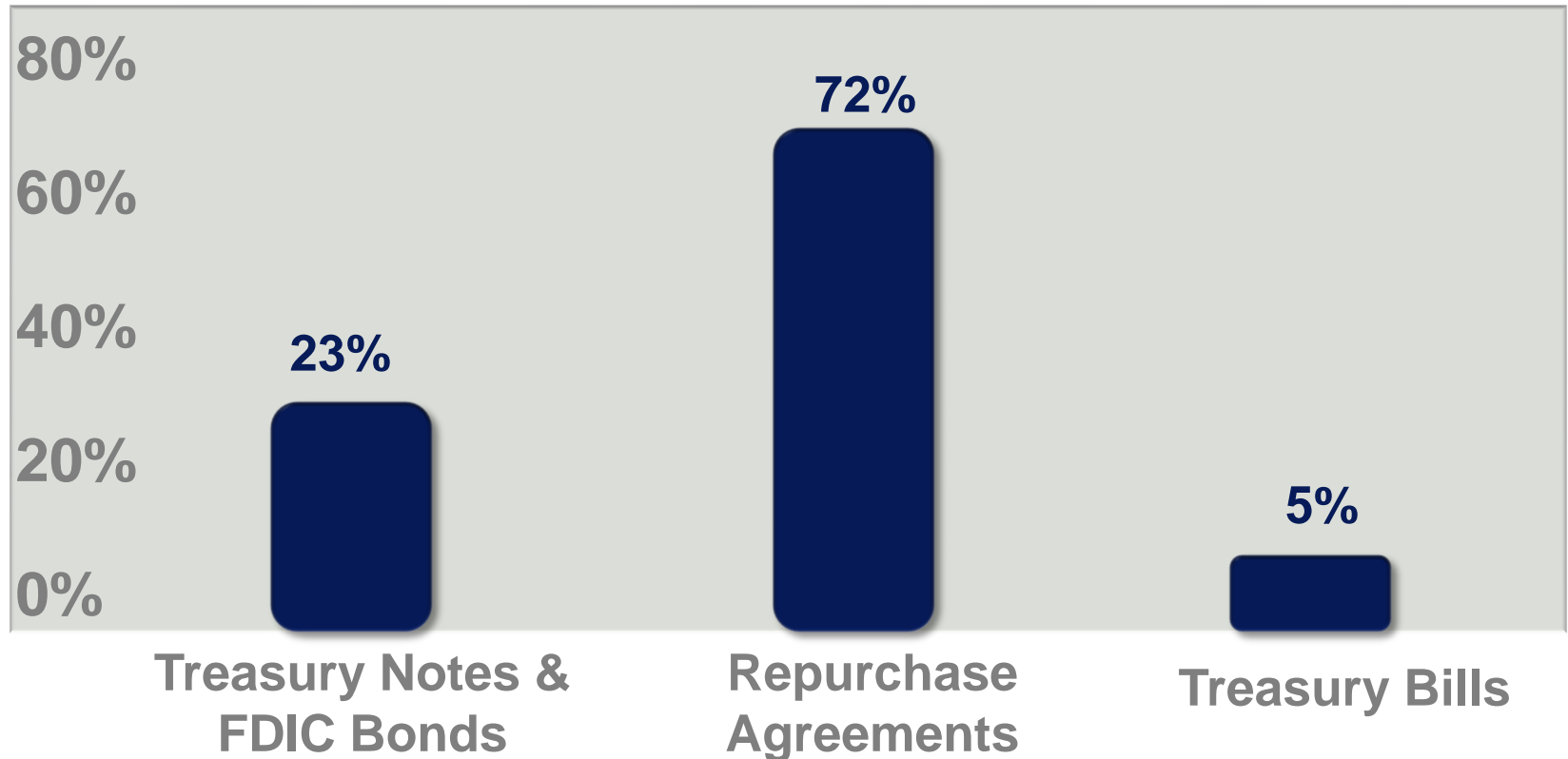


# Pool 7: Liquidity

Weighted Average Maturity: 39 days on 3/31/2011

**DURATION:** 100% from 0-1 yrs

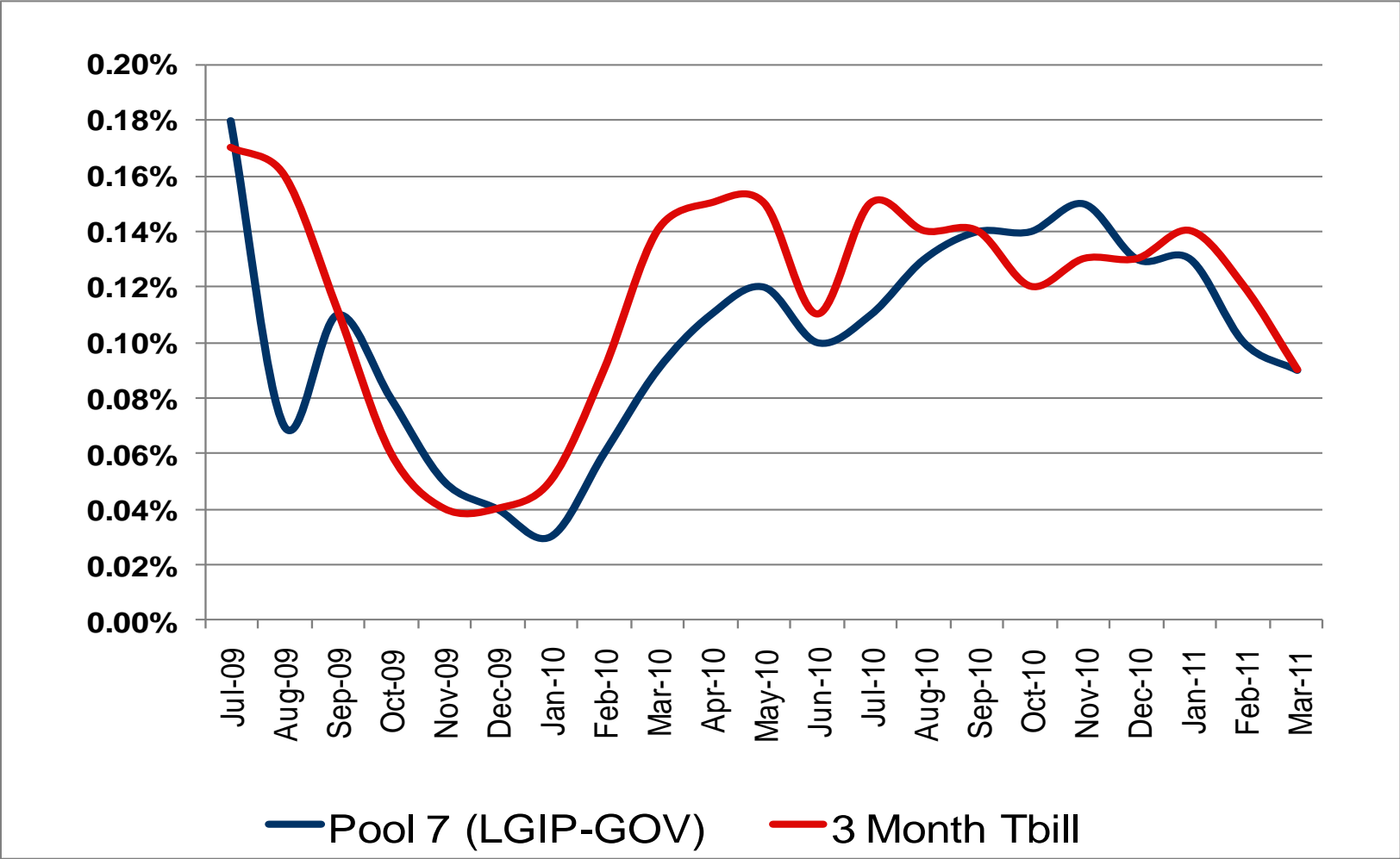
**ASSET MIX:**



# Pool 7: Yield

.12% YTD

.13% YTD (90 DAY T BILL)



# Pool 500: Overview

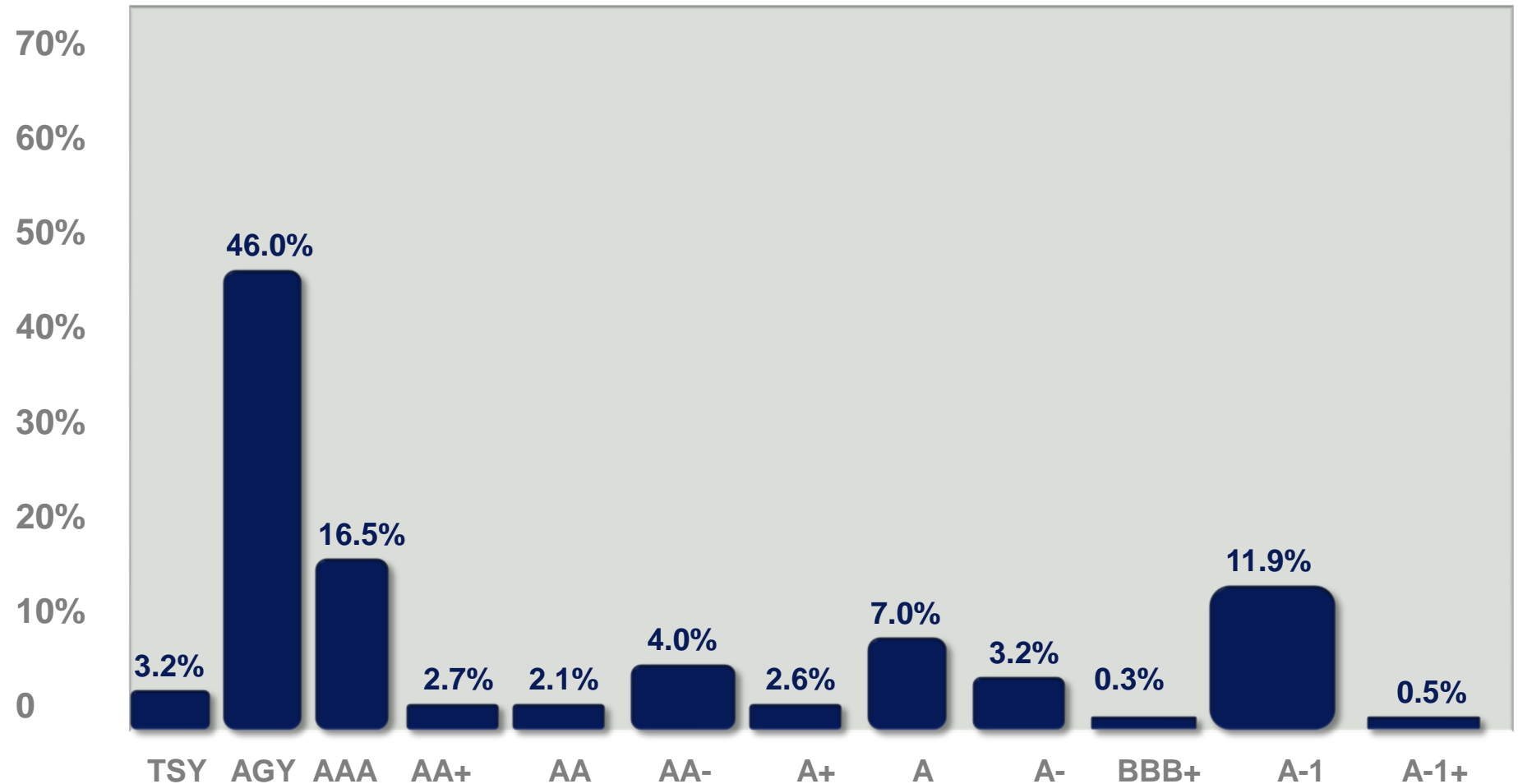
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- **\$208.6 million in assets as of 3/31/2011**
- **Floating Net Asset Value - \$1.0286 3/31/2011**
- **Will continue to invest in assets that provide a prudent diversification that takes advantage of prevailing market opportunities**
- **Keep maximum exposure to any credit at 2.5%**
- **Continue to target duration at one year less than the benchmark with 10% to 30% of the fund in liquid short term securities**



# Pool 500: Safety

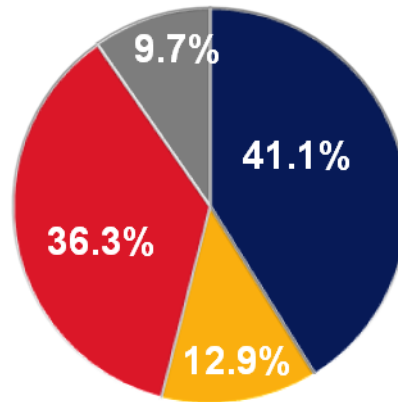
## AAA Weighted Average Rating



# Pool 500: Liquidity

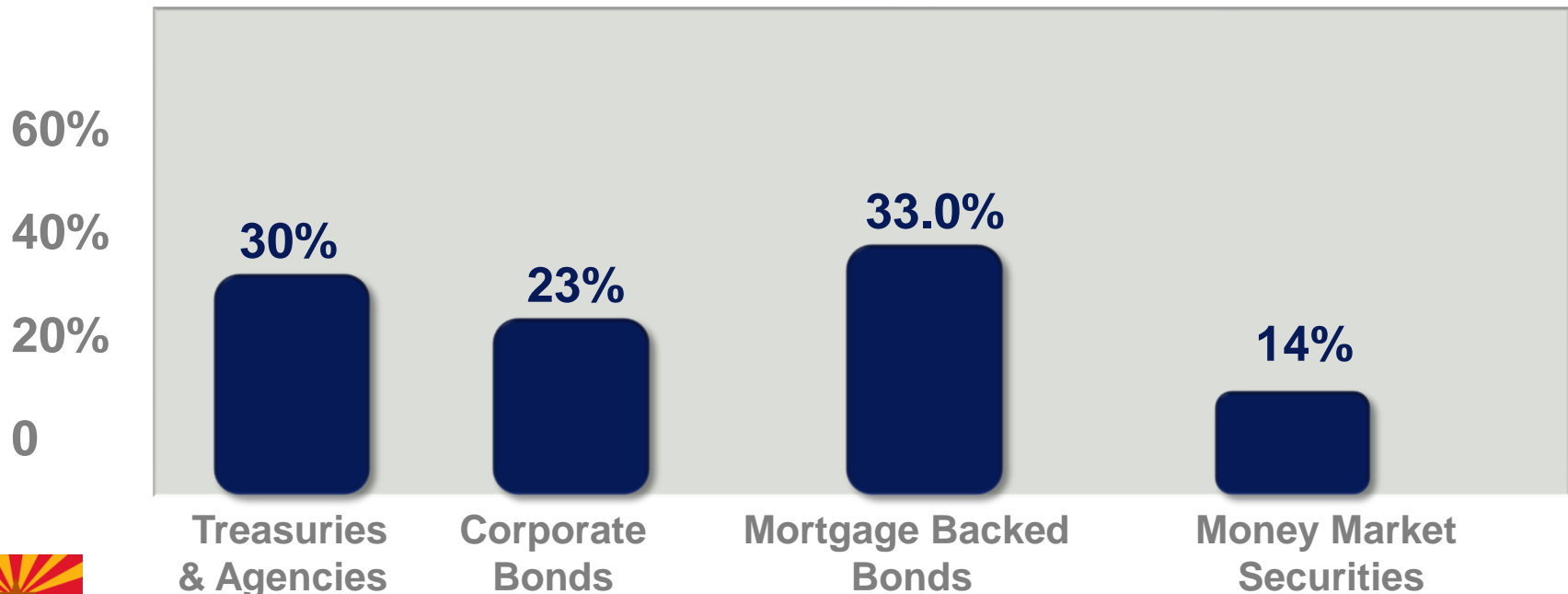
Effective Duration: 1.77 years on 3/31/2011

**DURATION:**



- Year 0 - 1
- Year 1 - 2
- Year 2 - 4
- Year 4 - 8

**ASSET MIX:**

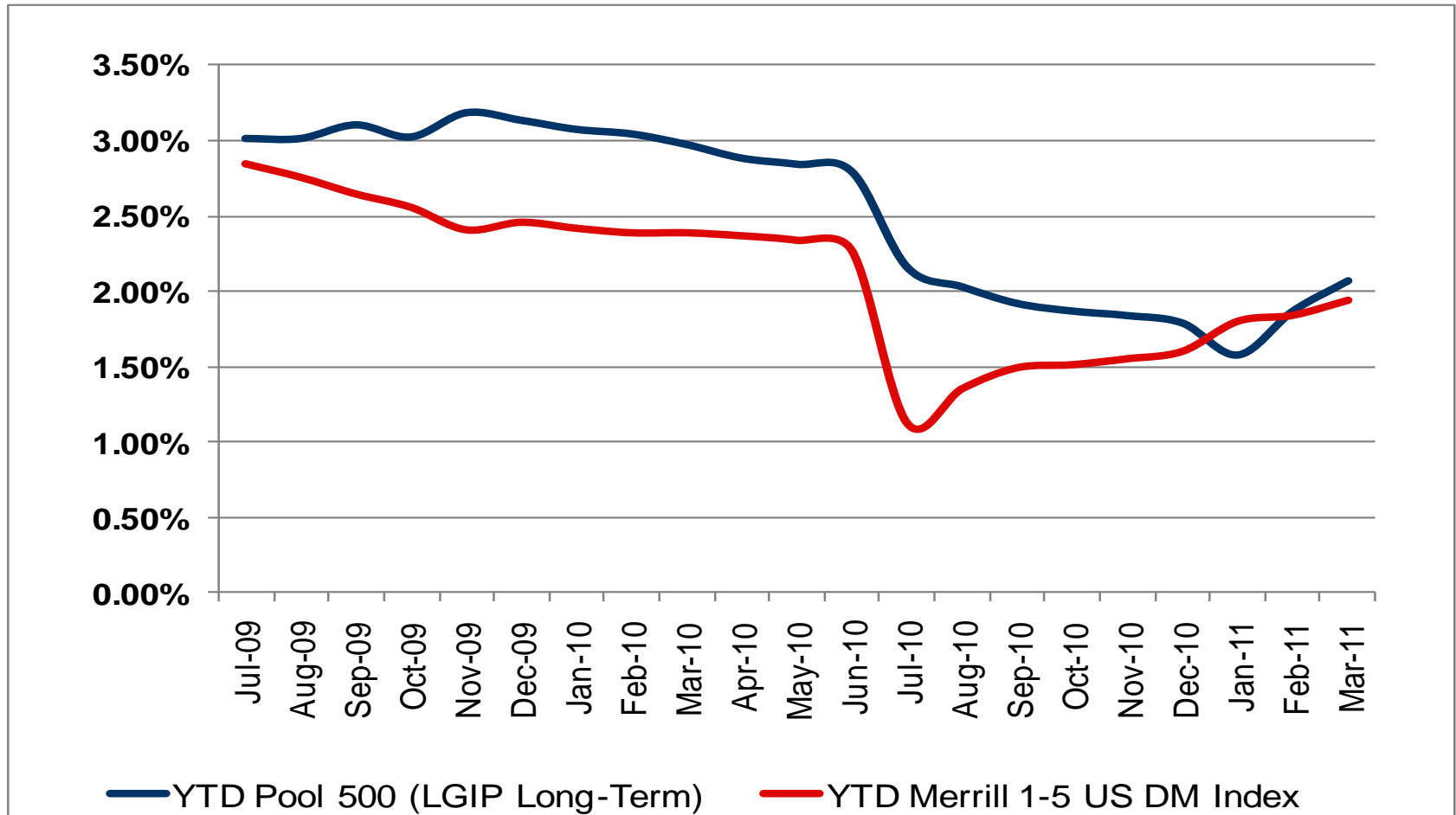




# Pool 500: Yield

1.81% YTD

1.68% YTD (Index)



# Pool 700: Overview

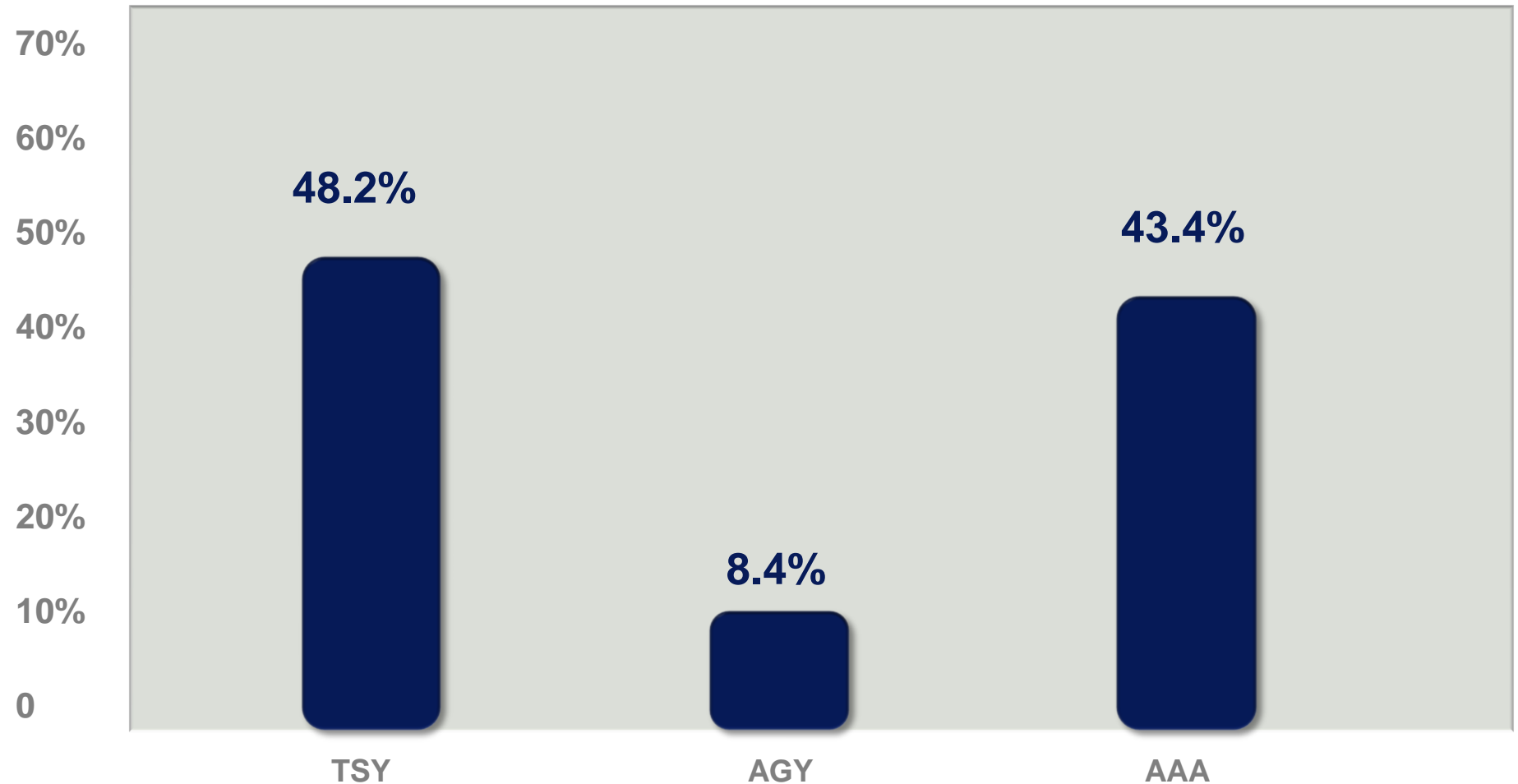
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- **\$110.5 million in assets as of 3/31/2011**
- **Floating Net Asset Value - \$ 1.0026 3/31/2011**
- **Strategy is to invest in a mix of 1-5 year US Treasuries, GNMA Mortgages and FDIC Paper**
- **All securities backed by US Government**
- **Continue to target duration at one year less than the benchmark with liquidity managed to meet withdrawal requests**



# Pool 700: Safety

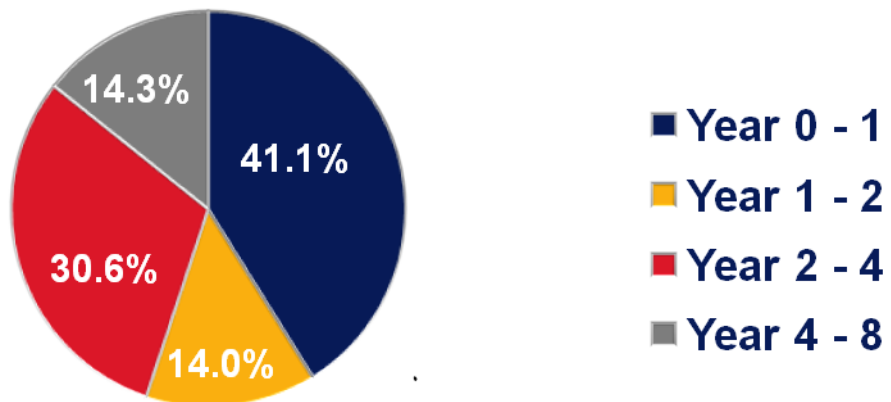
## AAA Weighted Average Rating



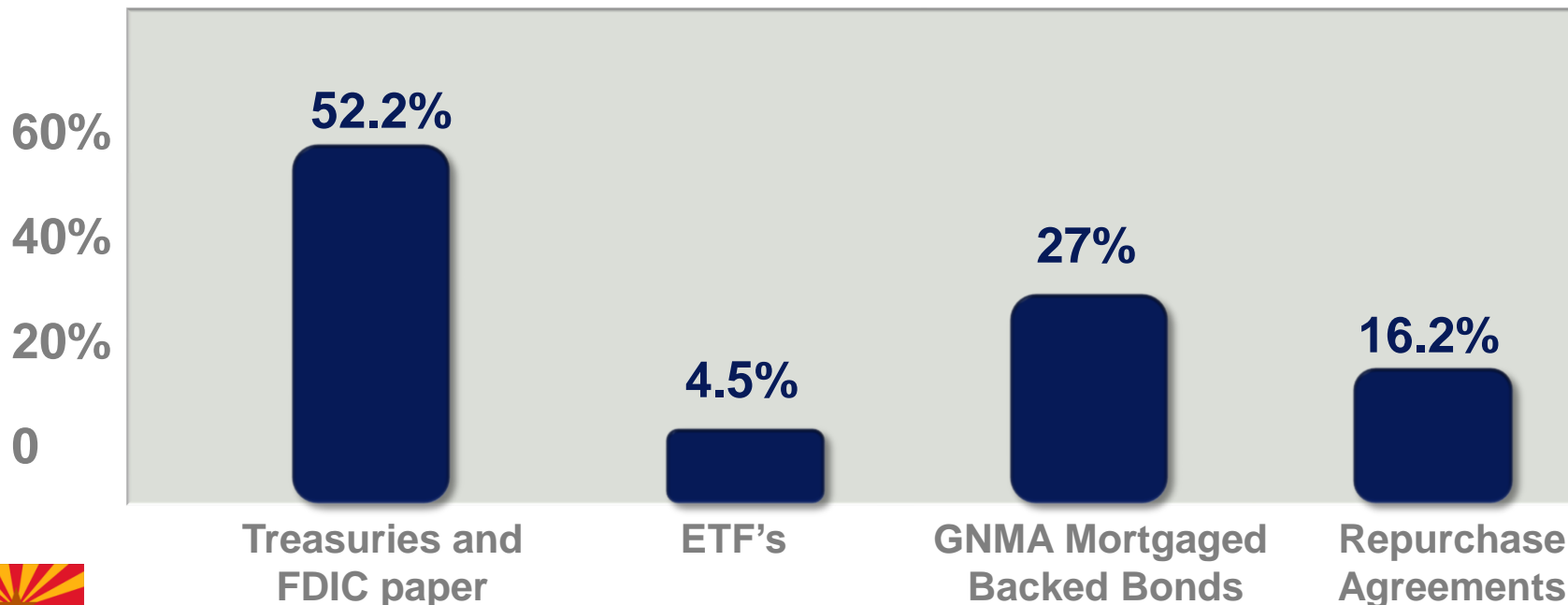
# Pool 700: Liquidity

Effective Duration: 1.85 years on 3/31/2011

## DURATION:

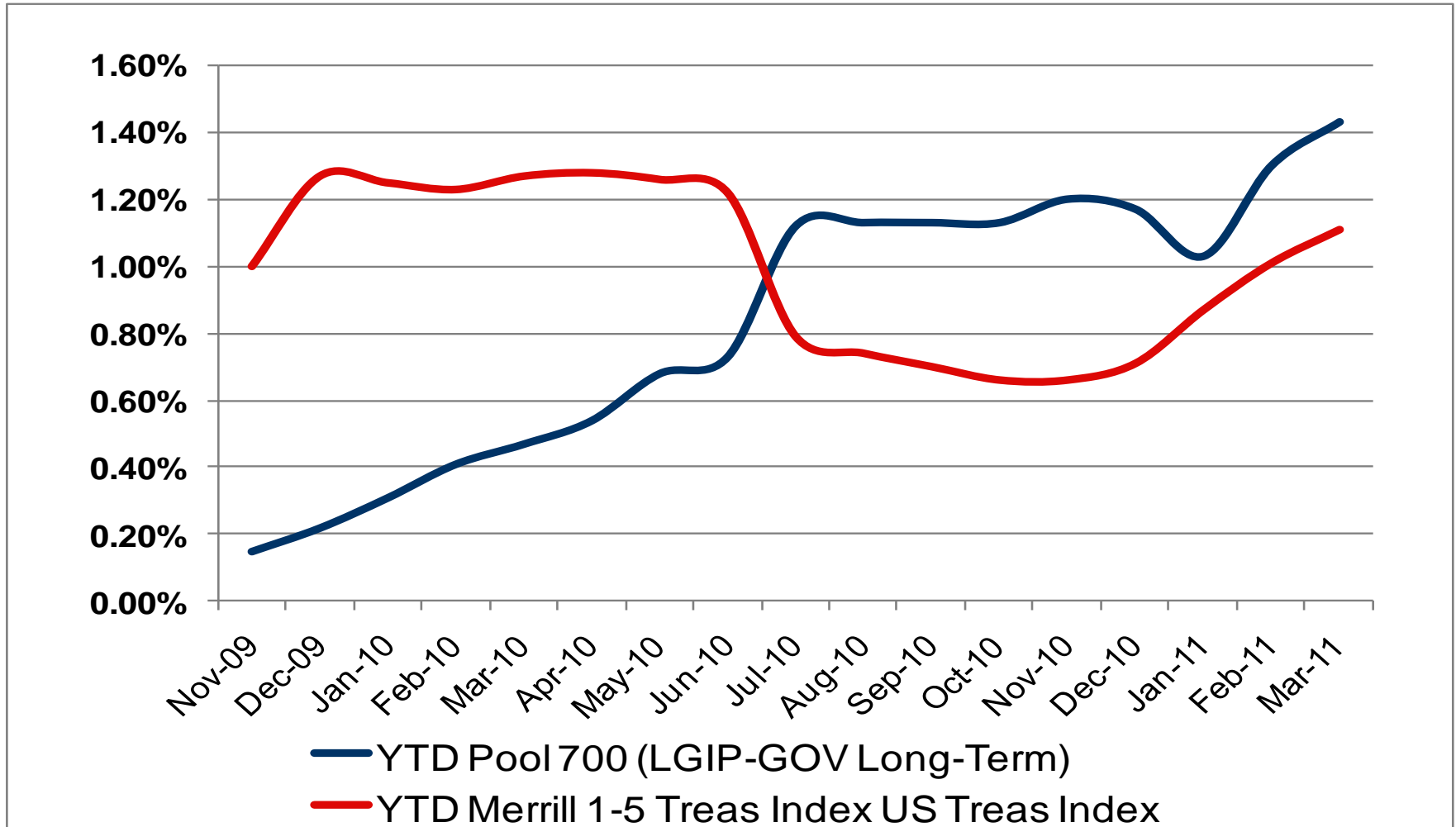


## ASSET MIX:



# Pool 700: Yield

**1.20% YTD    0.81% YTD (Index)**





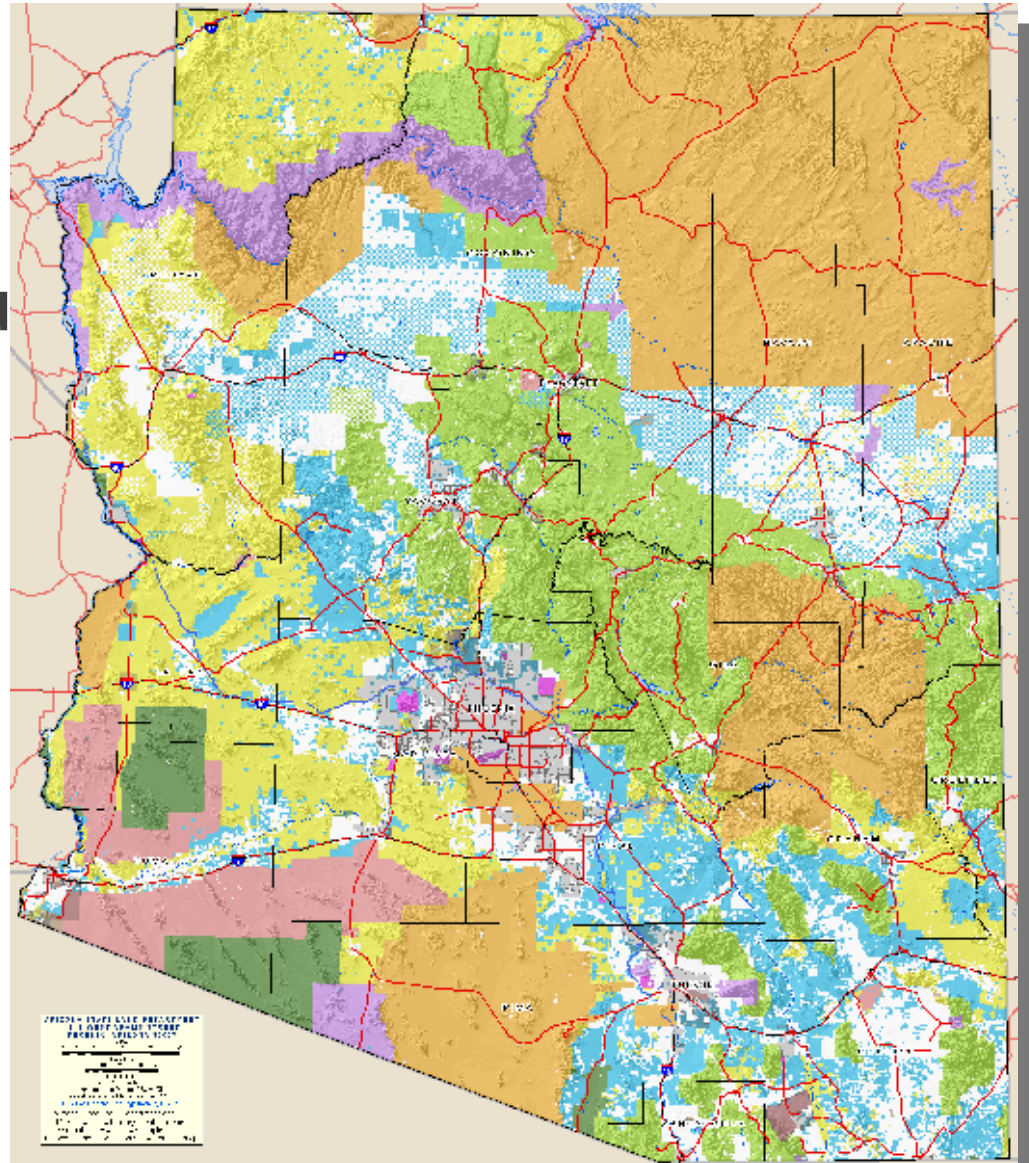
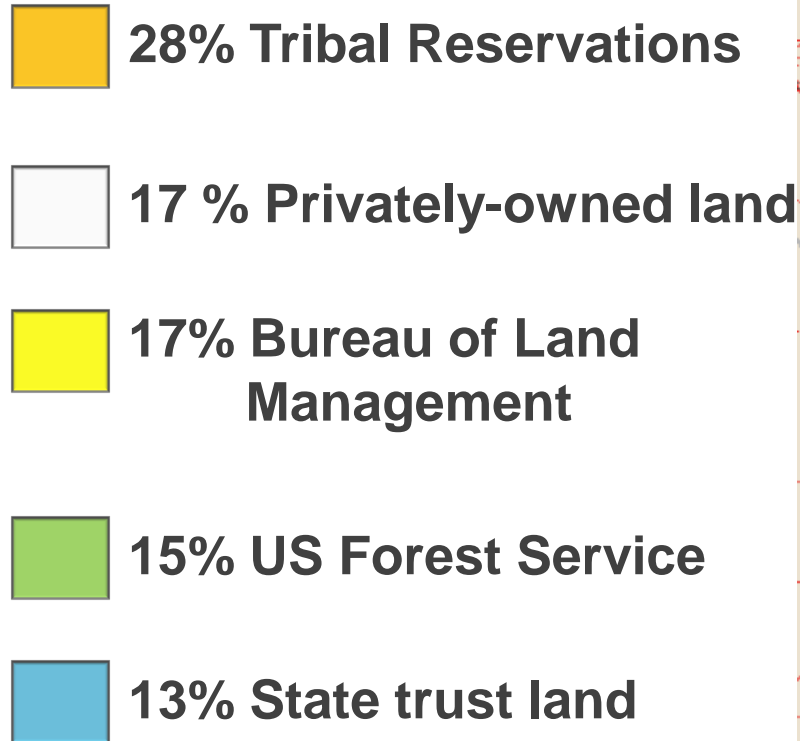
# Endowment Performance

Through March 2011

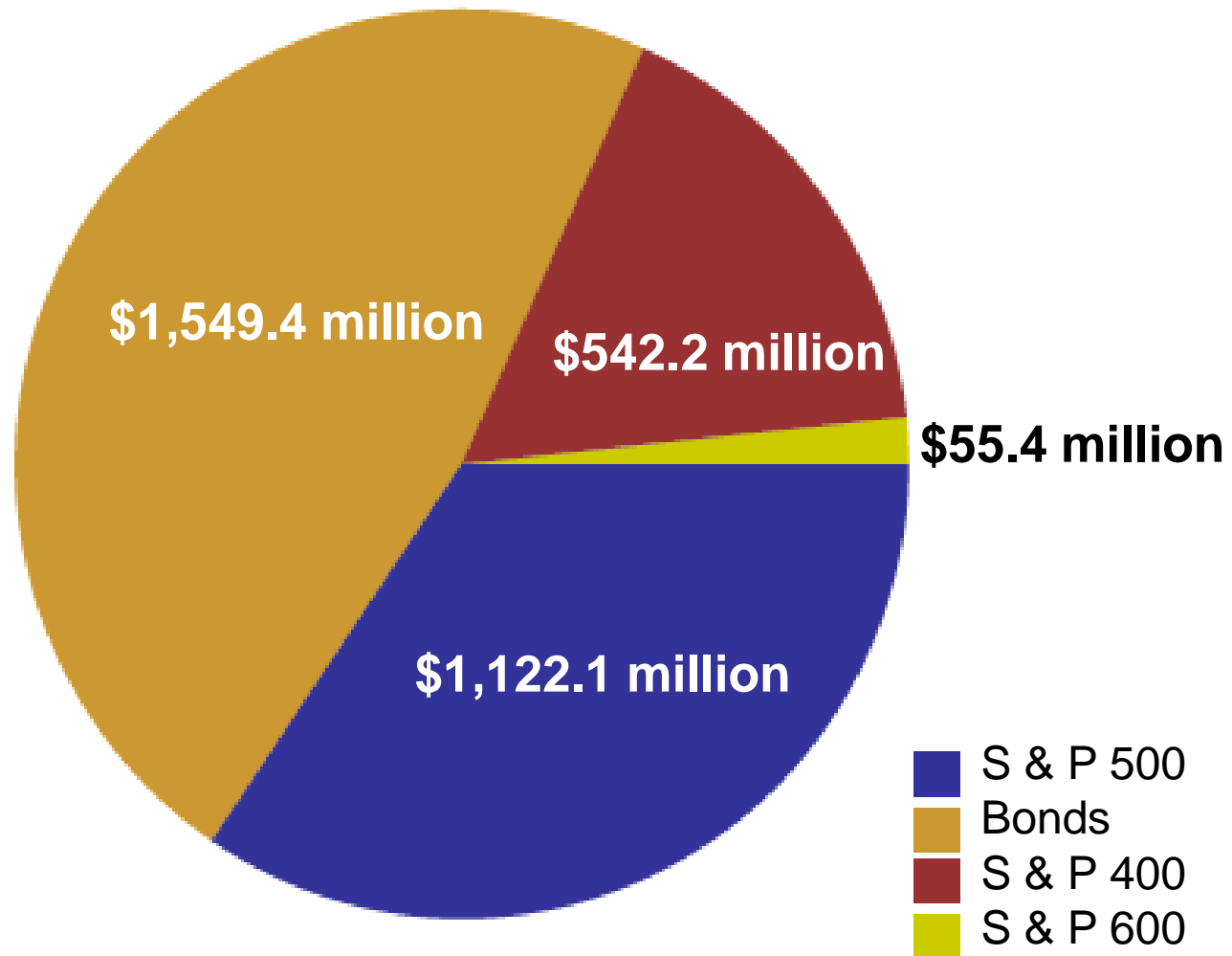
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# ENDOWMENT TRUST LANDS

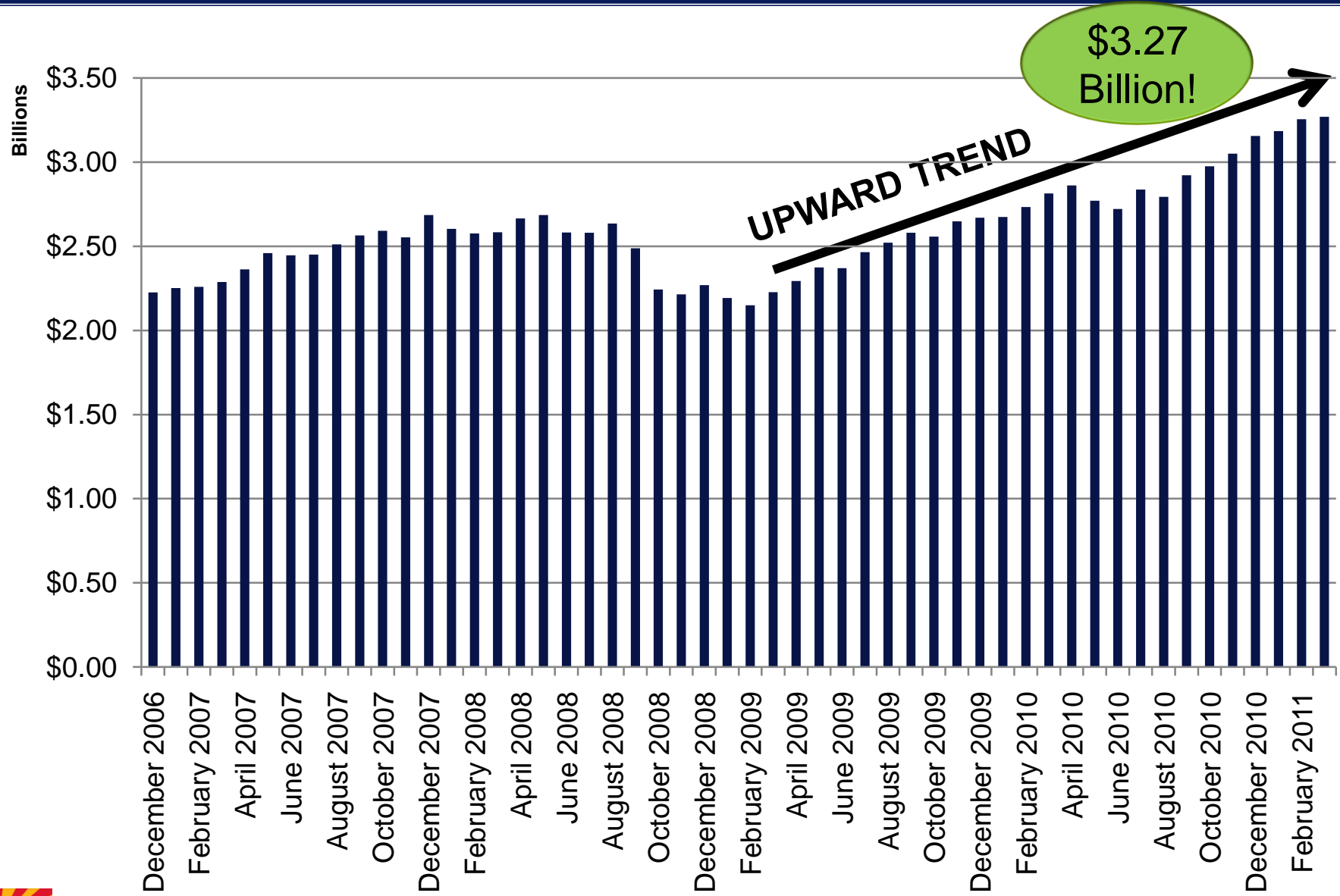


# ENDOWMENT ASSET ALLOCATION

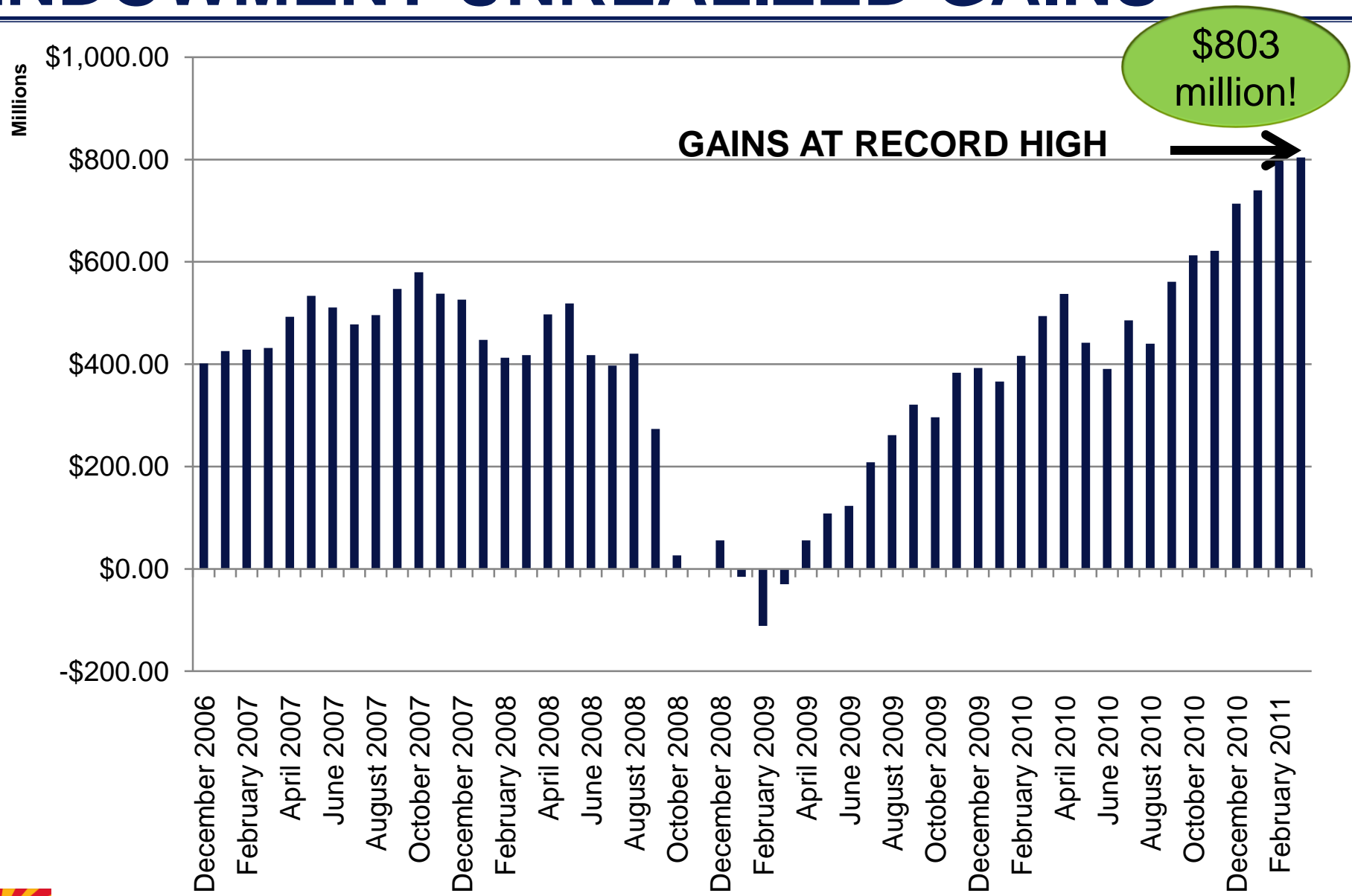




# ENDOWMENT MARKET VALUE

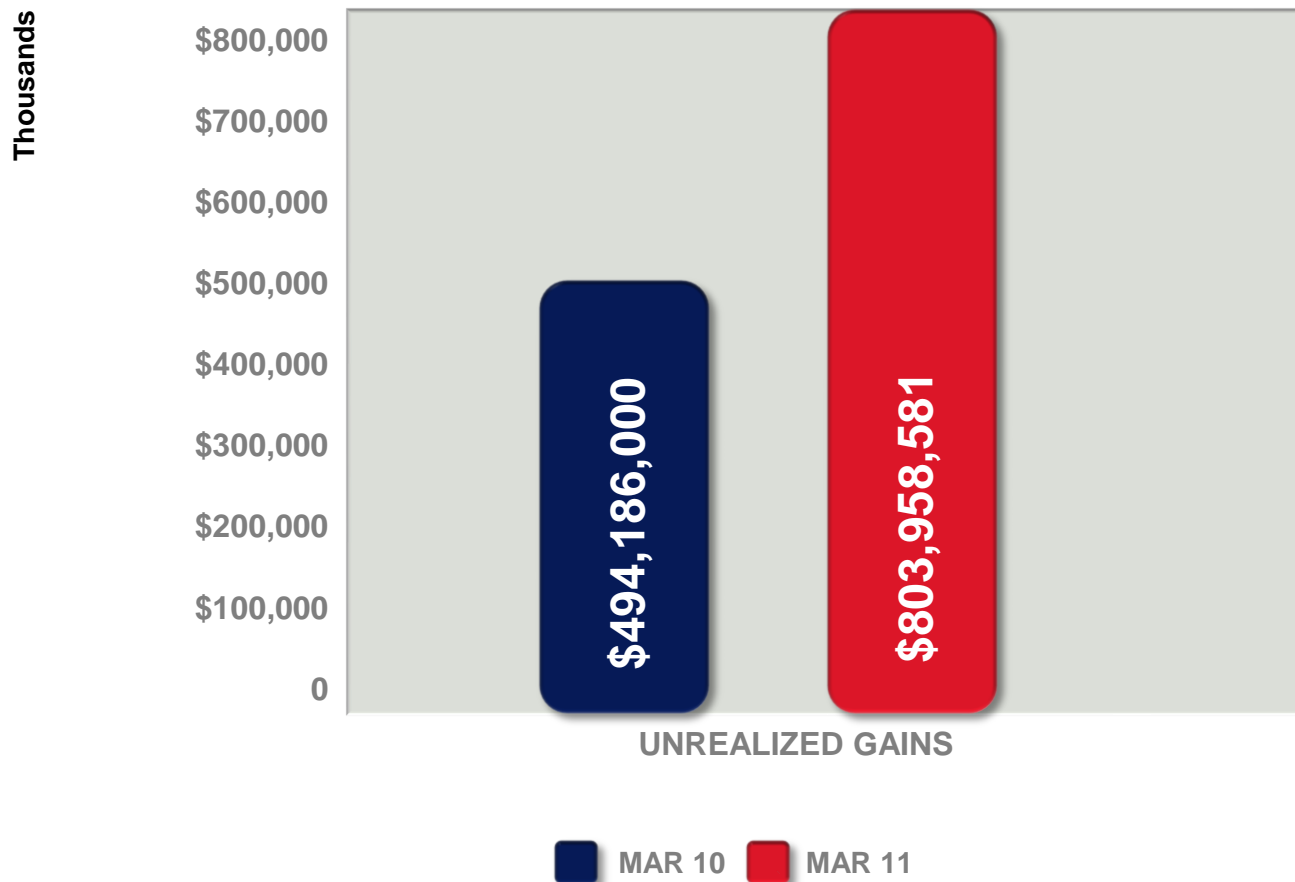


# ENDOWMENT UNREALIZED GAINS

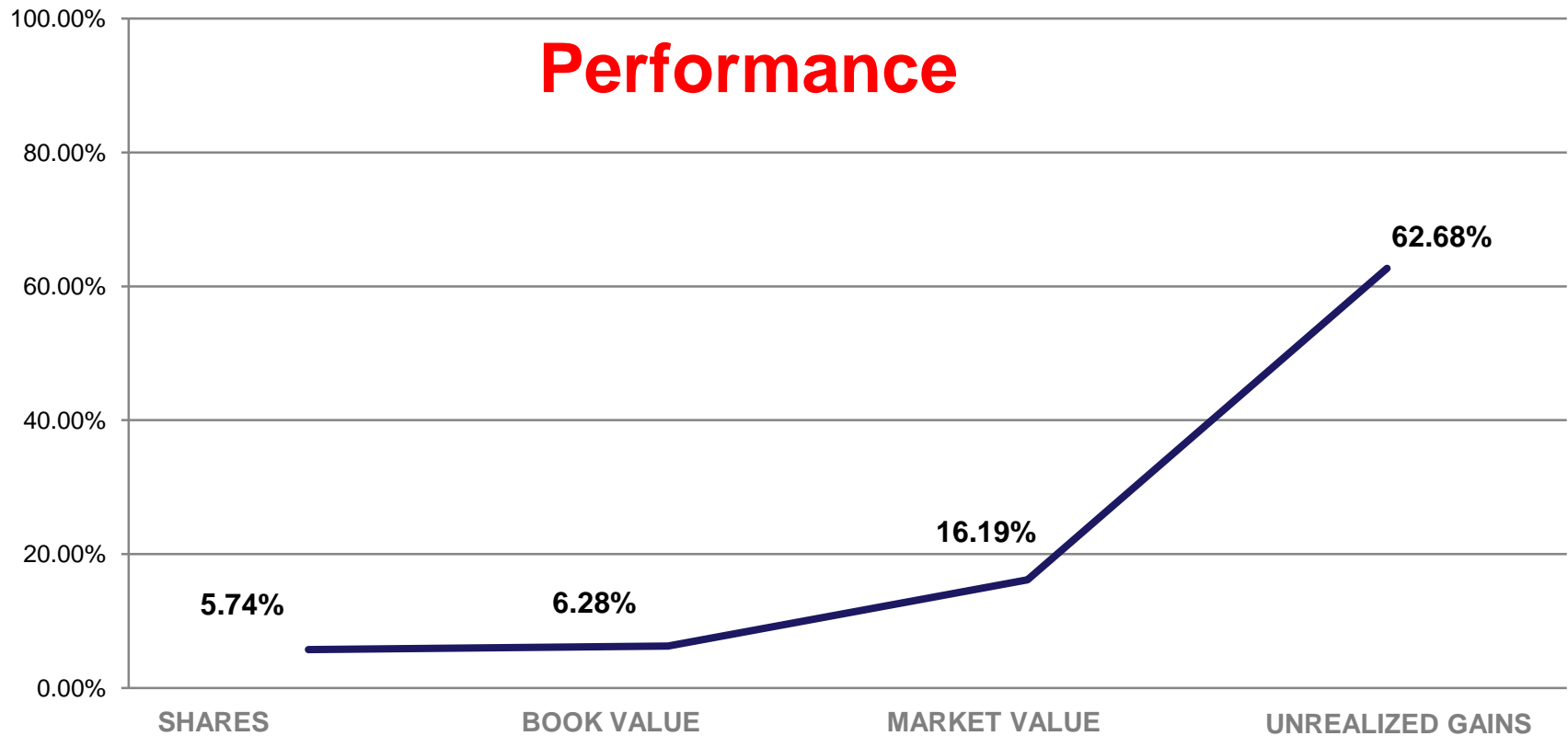


# ENDOWMENT Q3 FY 11

## CHANGE SINCE 2010



# ENDOWMENT FY 11 3rd QUARTER





# Endowment Asset Allocation Changes

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# ASSET ALLOCATION: 1999

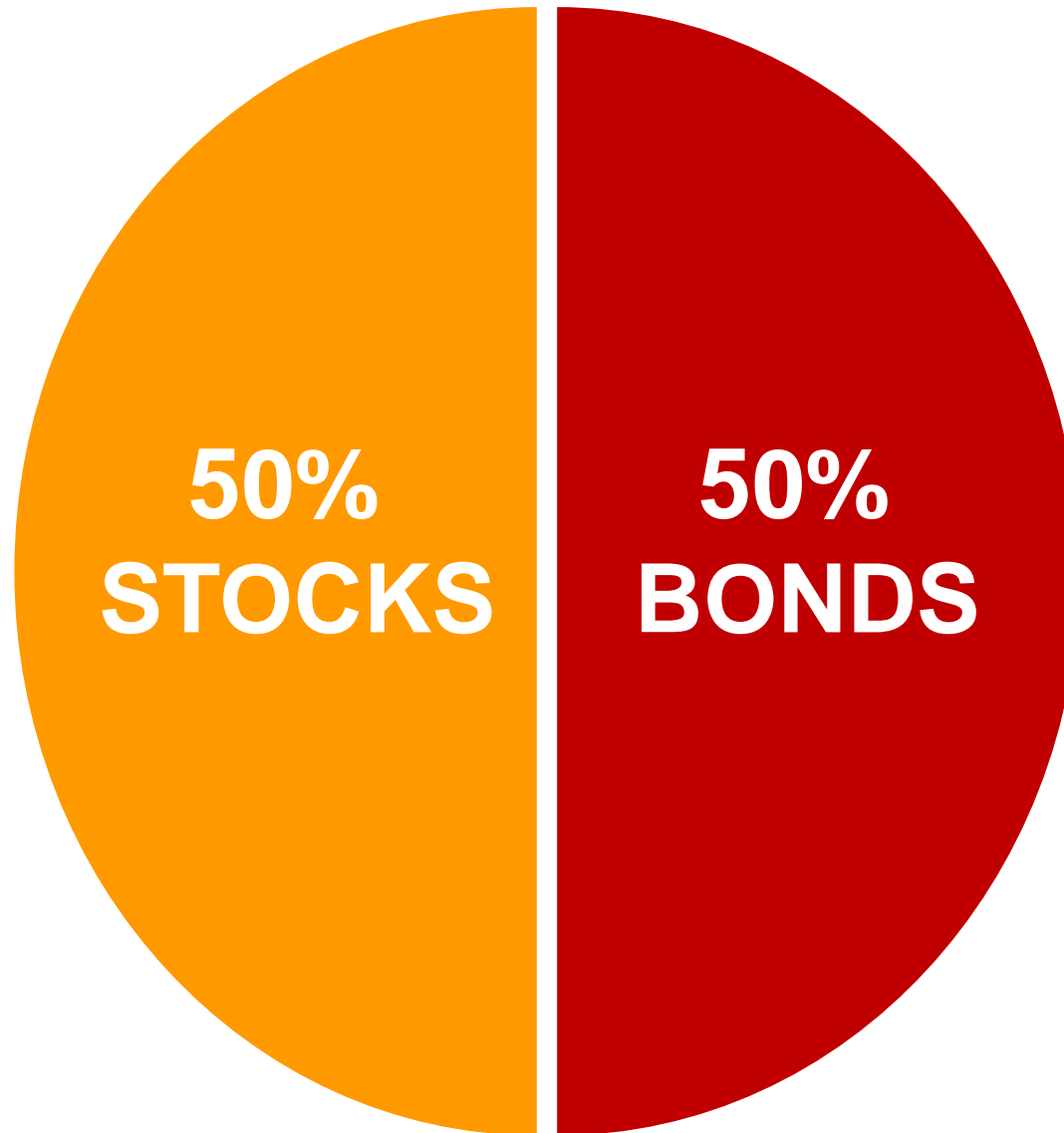
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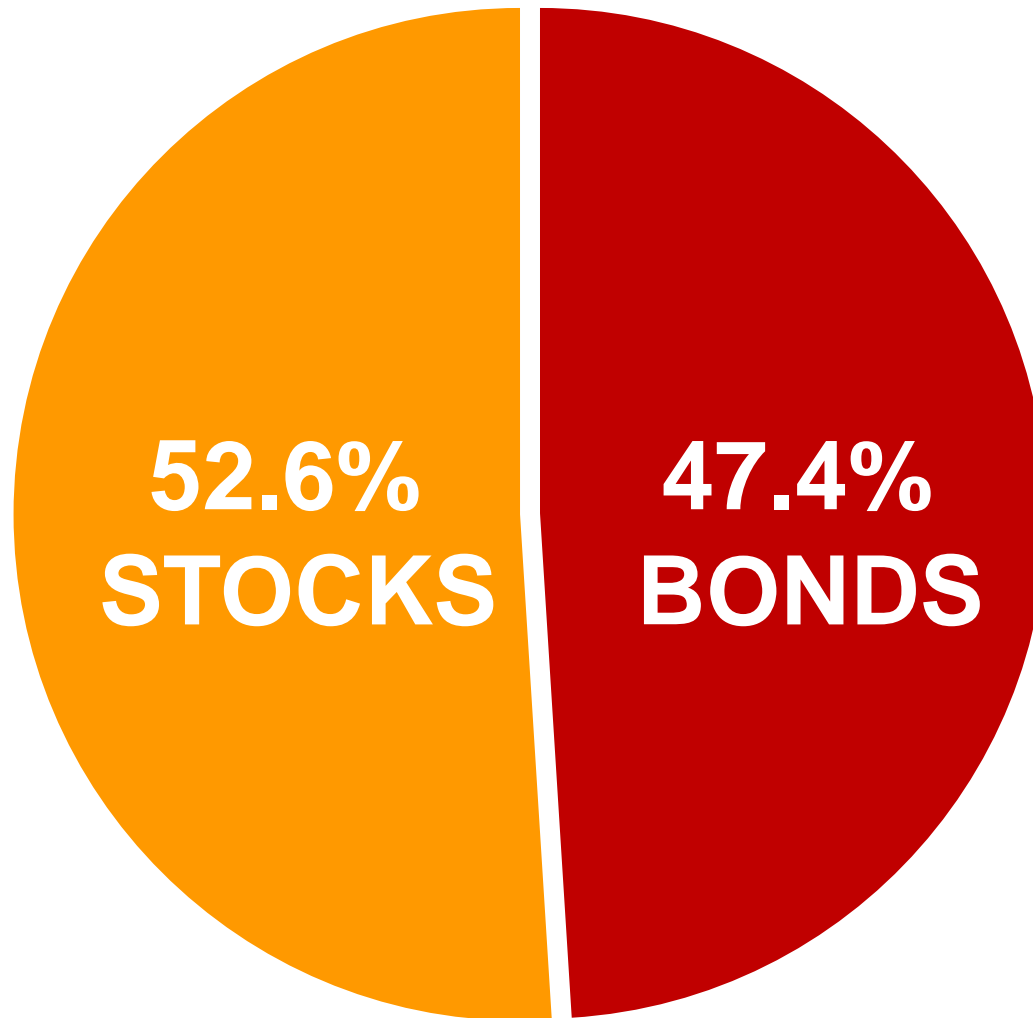
**100%  
BONDS**



# ASSET ALLOCATION: MARCH 2003

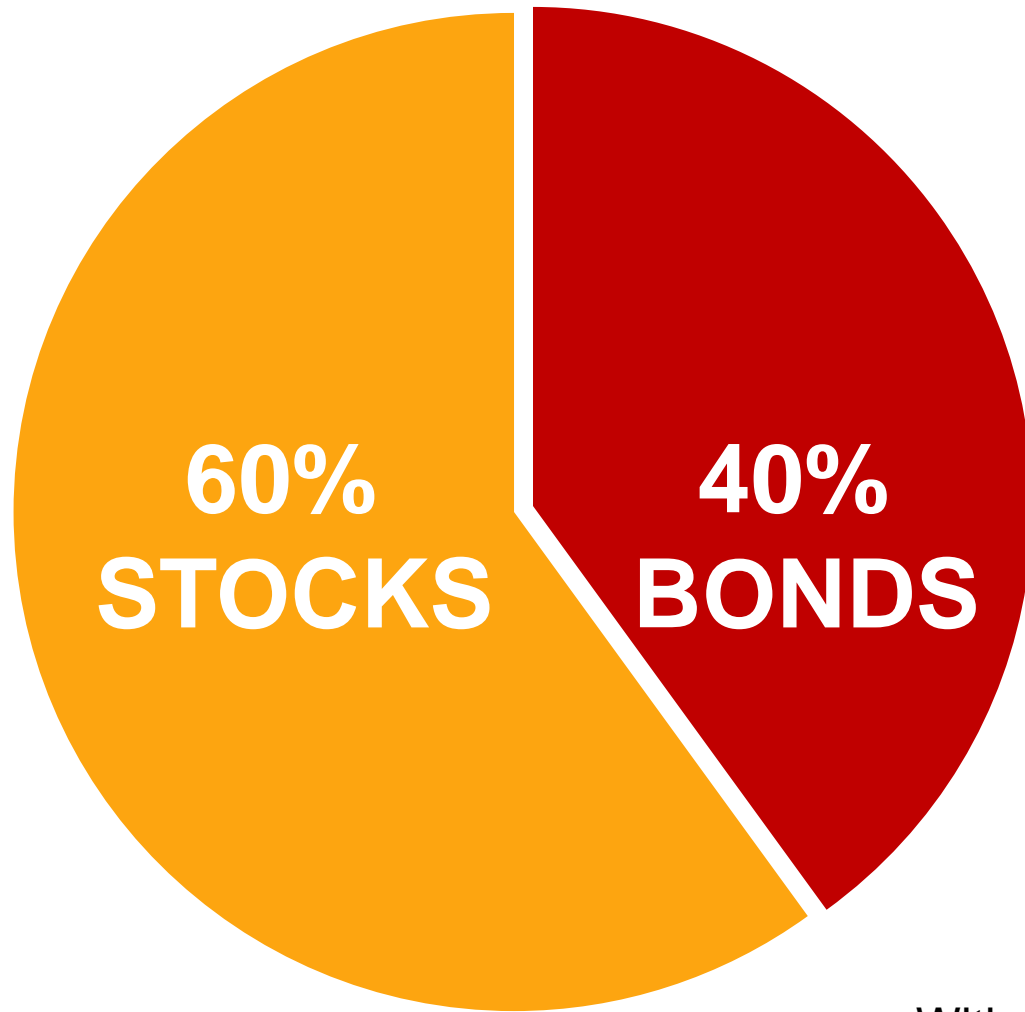


# ASSET ALLOCATION: MARCH 2011





# TARGET ASSET ALLOCATION: FEB 2012



With +/- 5% market value  
rebalance triggers.

**Sell high, buy low.**



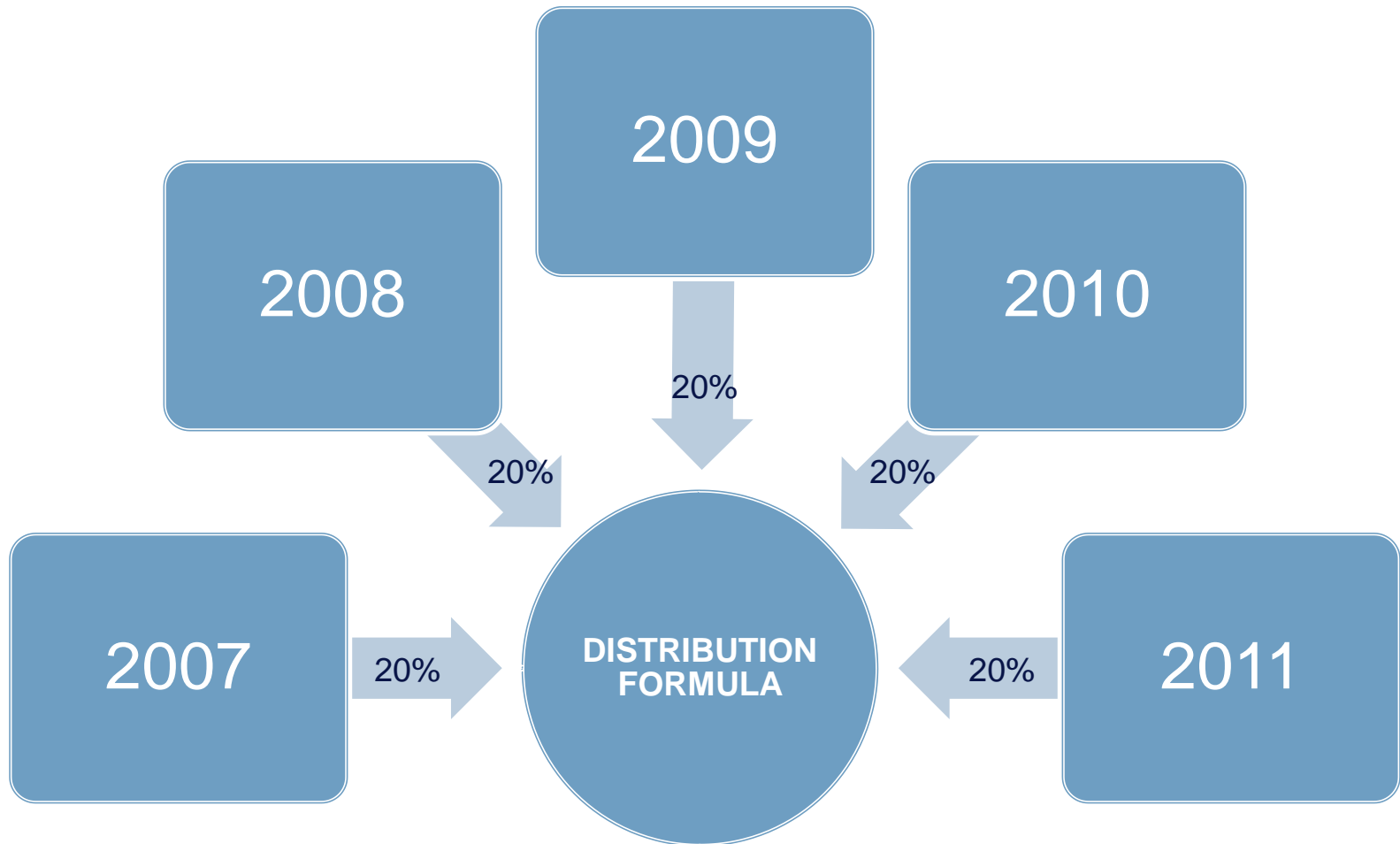


# Endowment Distribution Formula

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# ADJUSTED FOR INFLATION

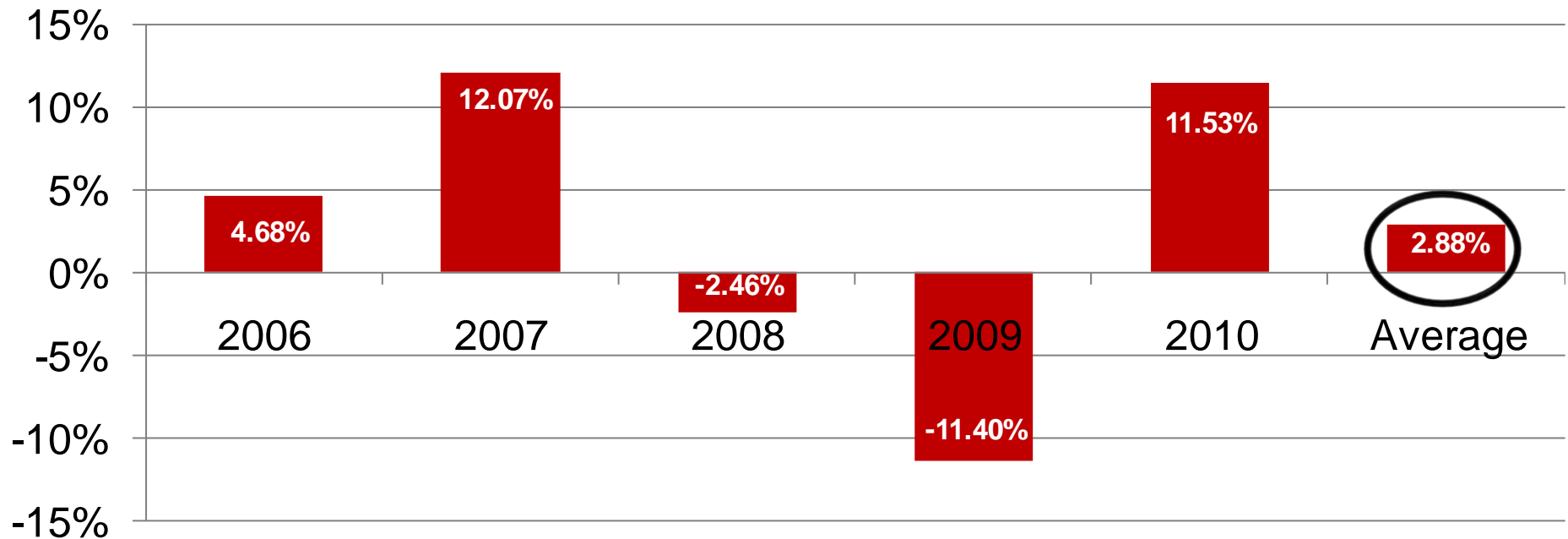


Formula takes 20% of the returns adjusted for inflation from each of the previous five years.



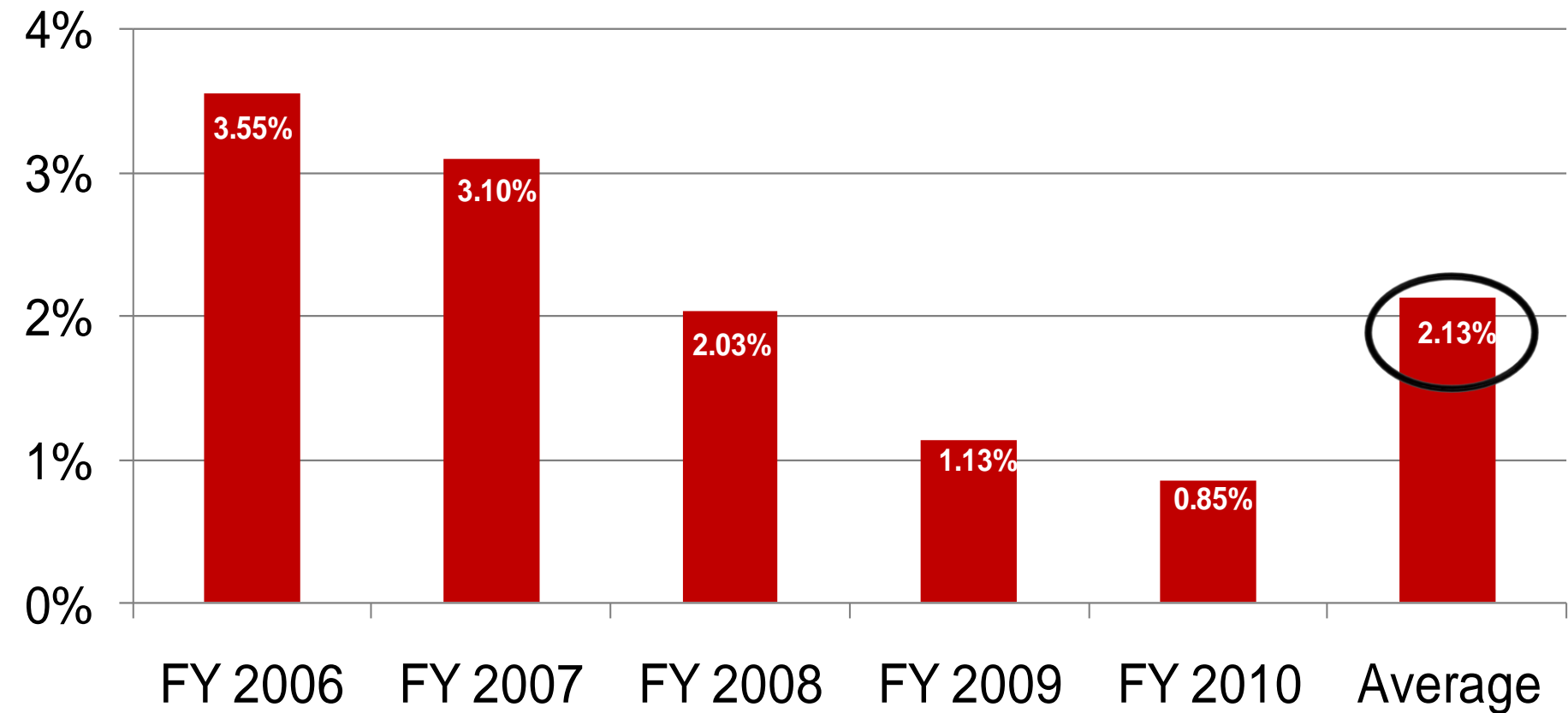
# HOW THE FORMULA WORKS

**5-YEAR AVG. TOTAL RETURN : 2.88%**



# HOW THE FORMULA WORKS

***SUBTRACT*** 5-YEAR AVGERAGE INFLATION: 2.13%

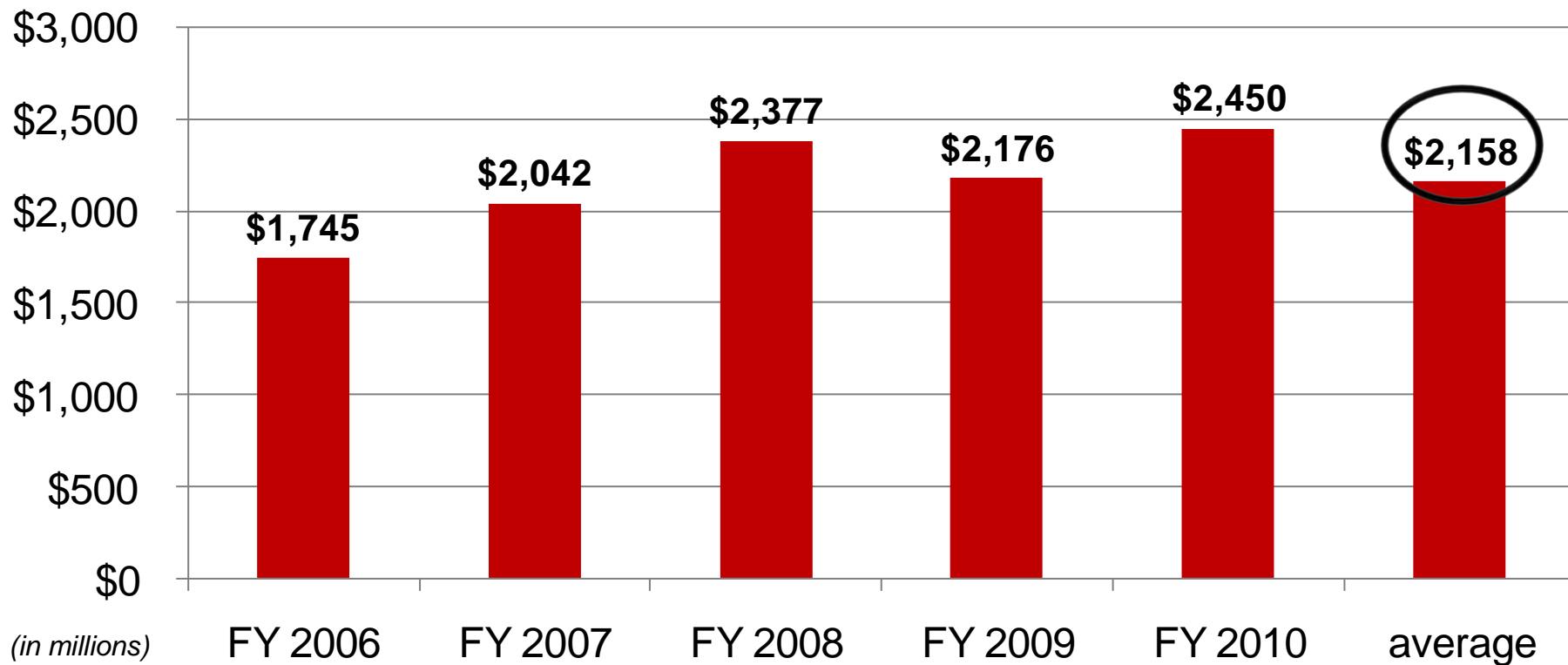


$$2.88\% - 2.13\% = .75\%$$



# HOW THE FORMULA WORKS

Equals .75% multiplied by 5-year average market value of \$2.158 billion

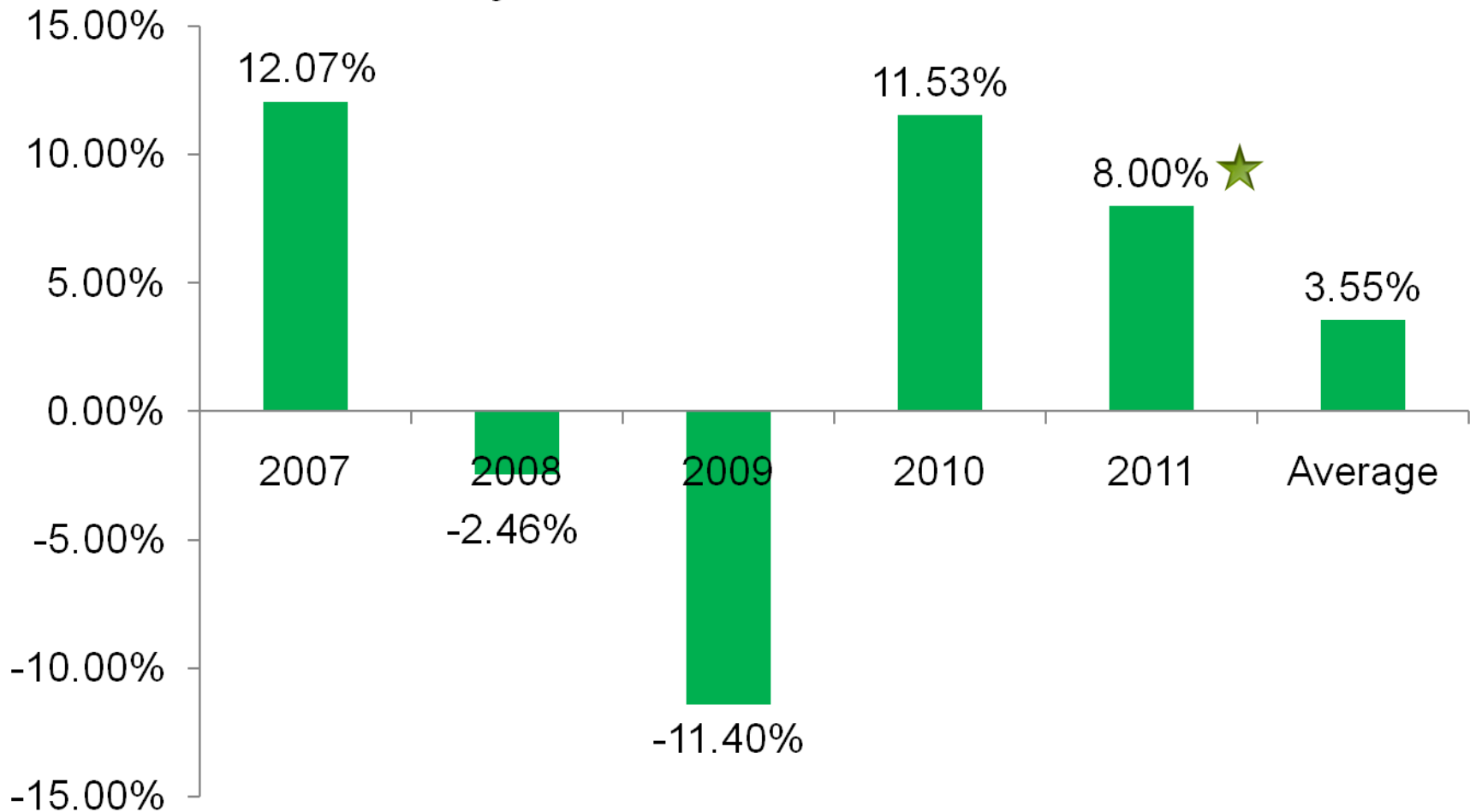


$$.75\% \times \$2.158\text{B} = \$16.2\text{M}$$



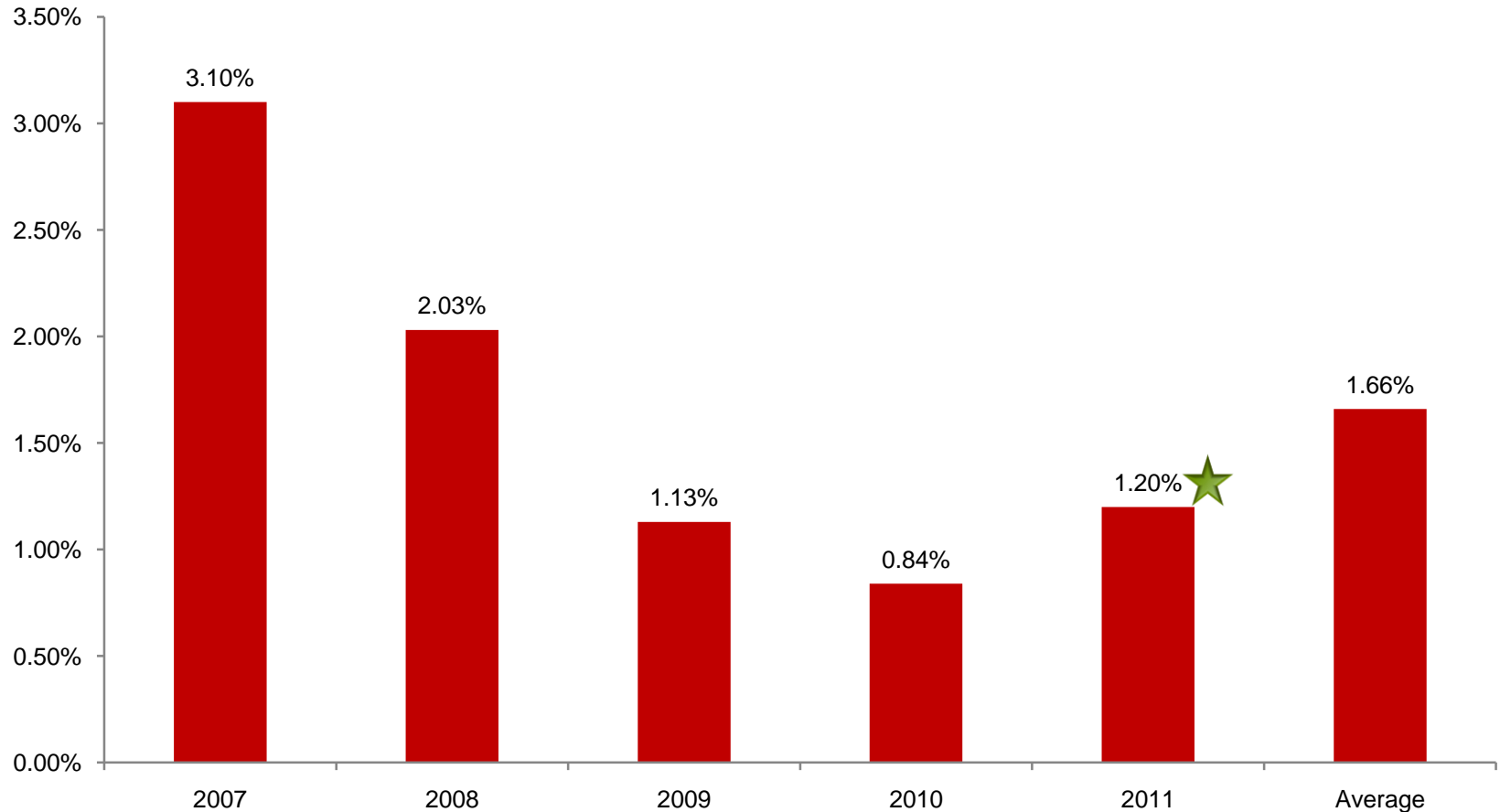
# 2012 PRELIMINARY ESTIMATE

**5-year total return of 3.55%**



# 2012 PRELIMINARY ESTIMATE

**5-year total inflation of 1.66%**



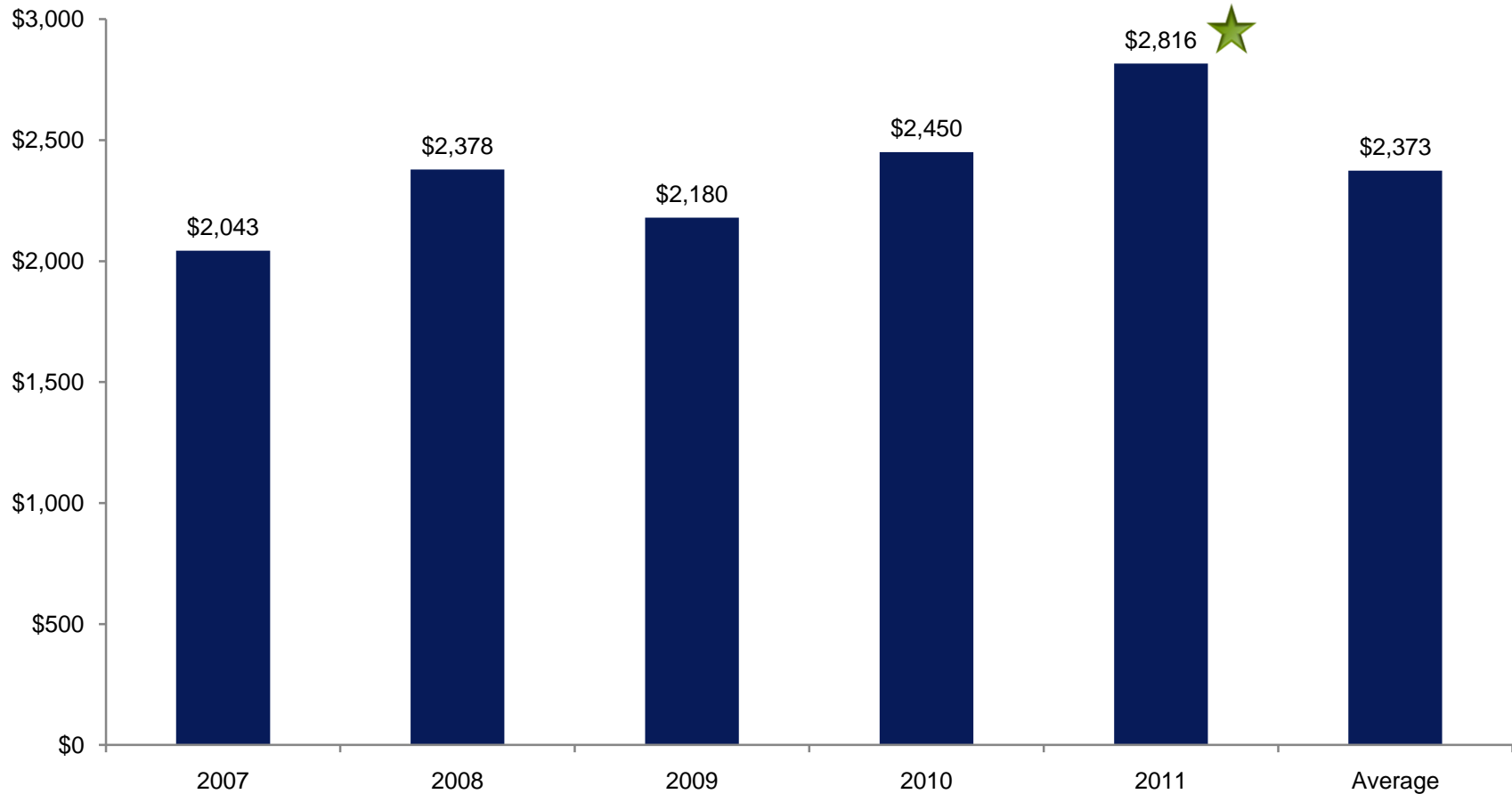
**3.55% - 1.66% = 1.89%**





# 2012 PRELIMINARY ESTIMATE

5-year average market value of \$2.4 billion



$$1.89\% \times \$2.373\text{B} = \$44.8\text{M}$$





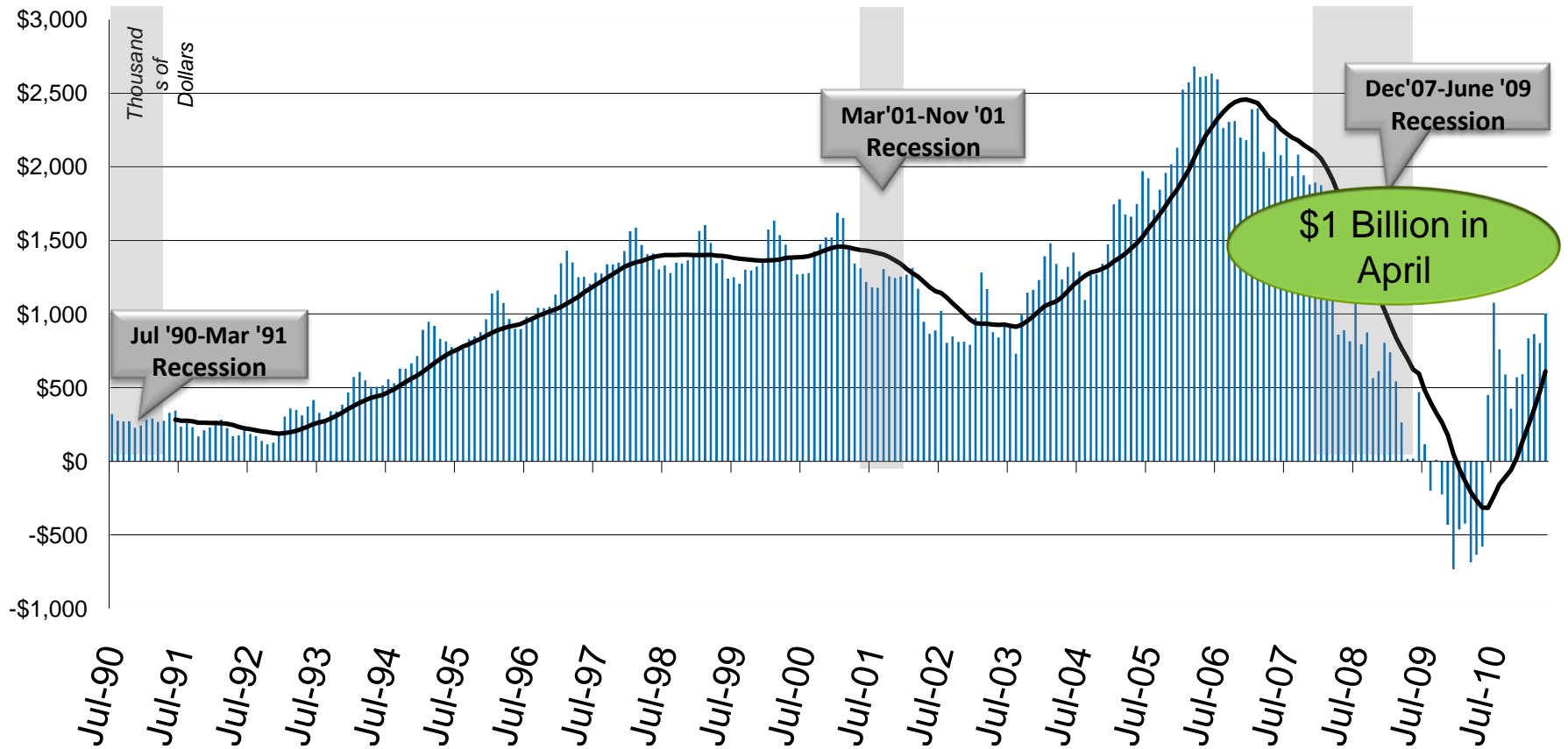
# State Cash Flow

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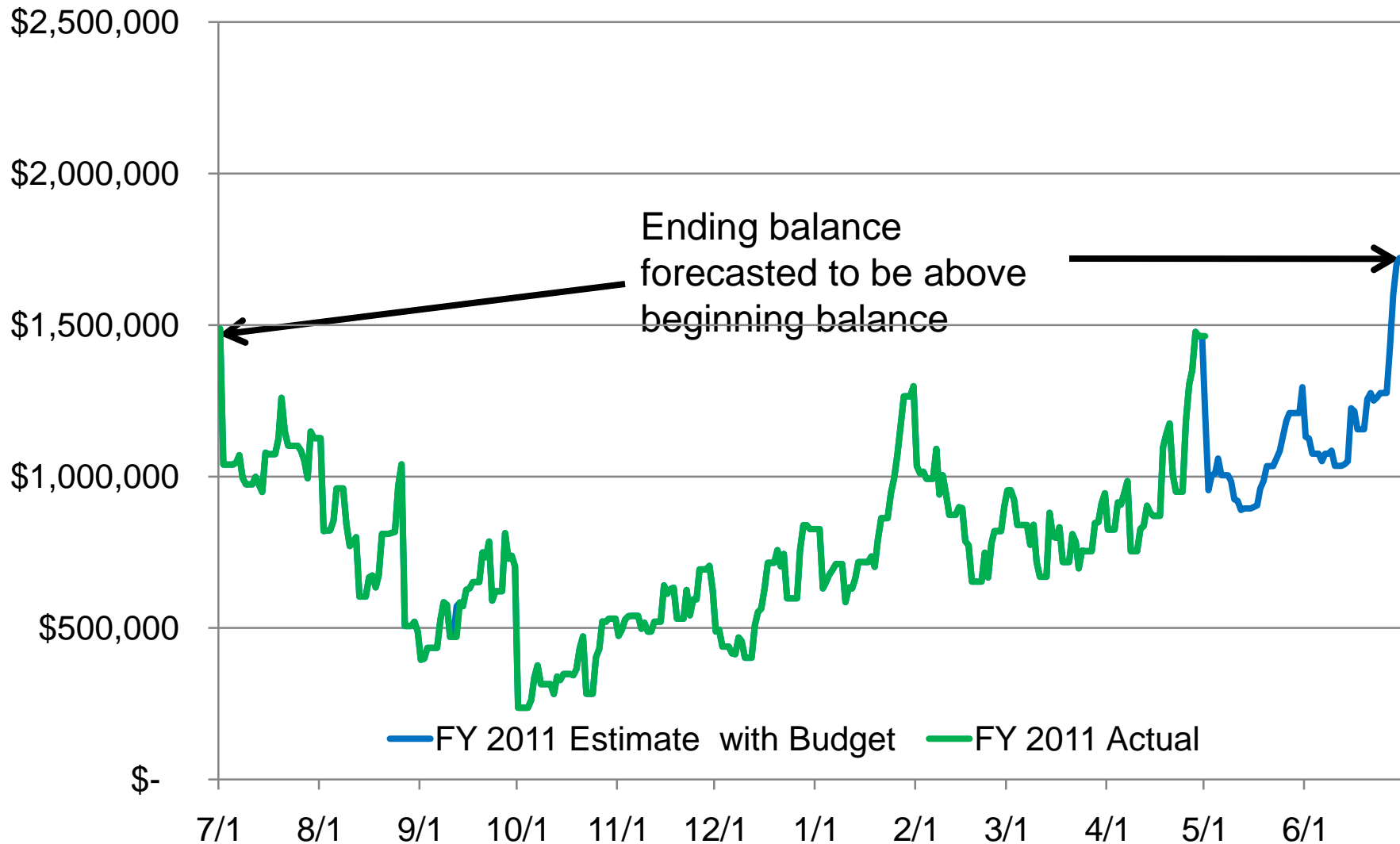


# STATE CASH FLOW

## TOTAL OPERATING ACCOUNT AVERAGE MONTHLY BALANCE BACK IN BLACK



# STATE CASH FLOW



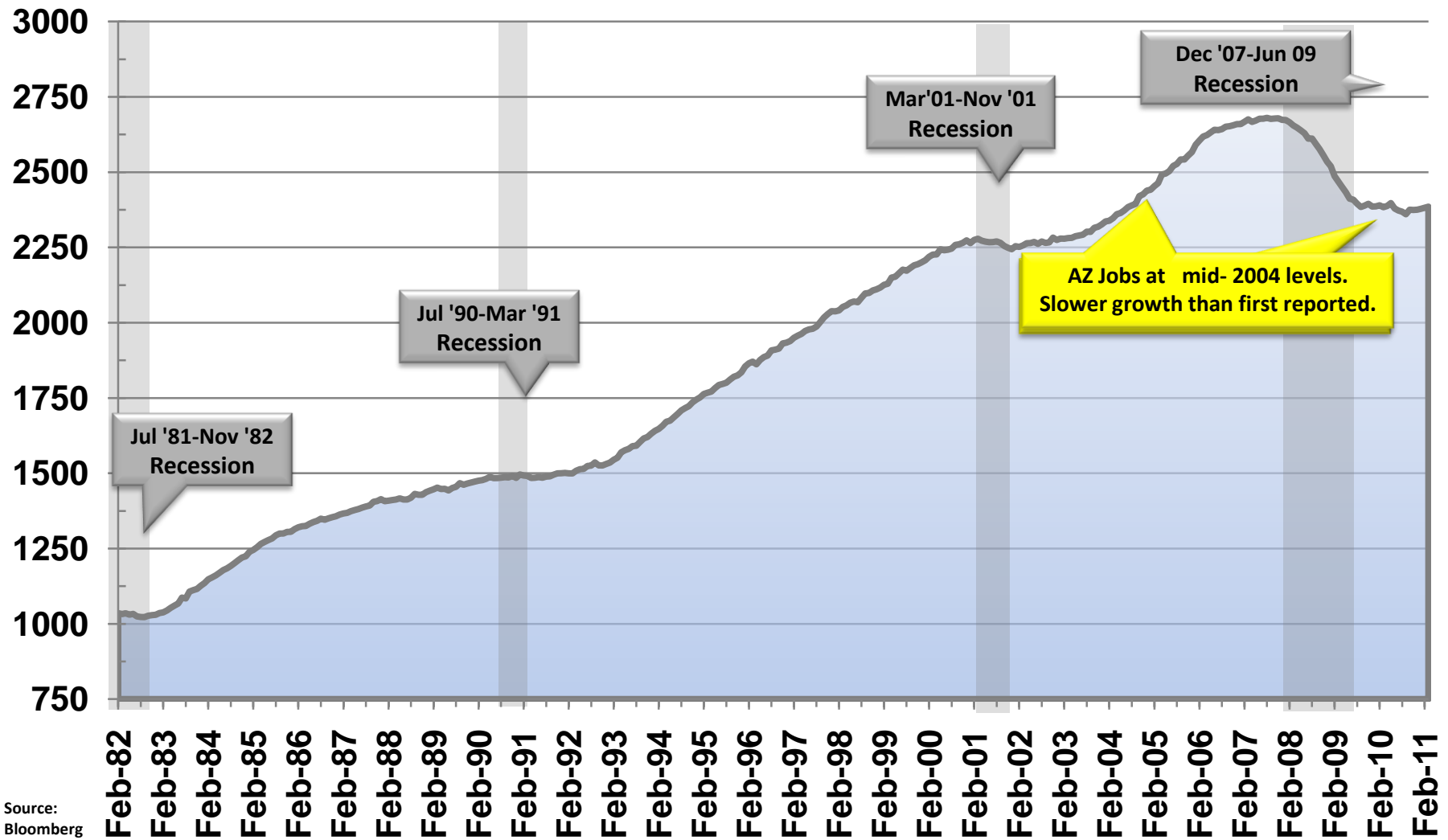


# ARIZONA ECONOMIC UPDATE

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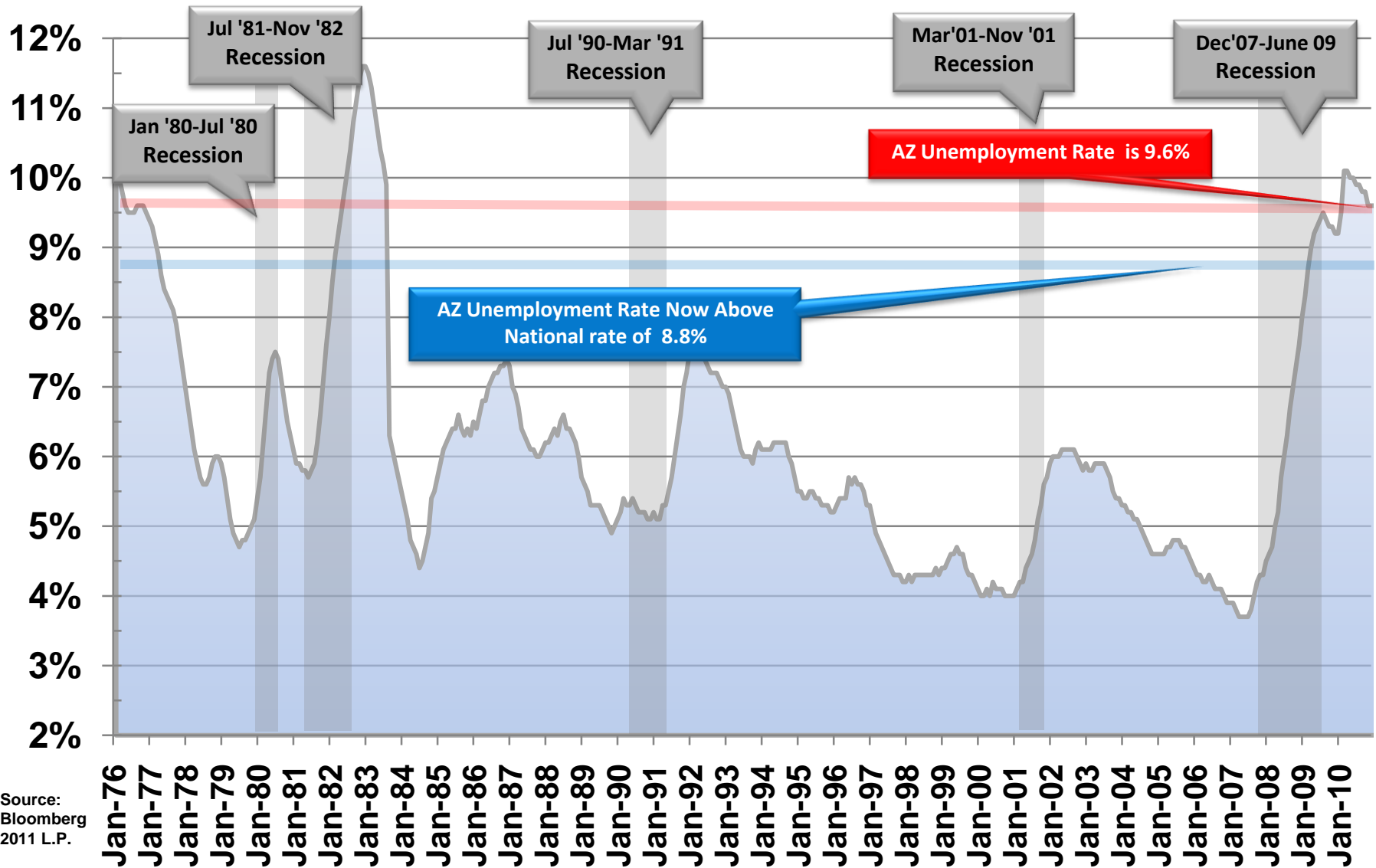
# AZ NON-FARM EMPLOYMENT



Source:  
Bloomberg  
2011 L.P.



# AZ UNEMPLOYMENT AT 9.6%

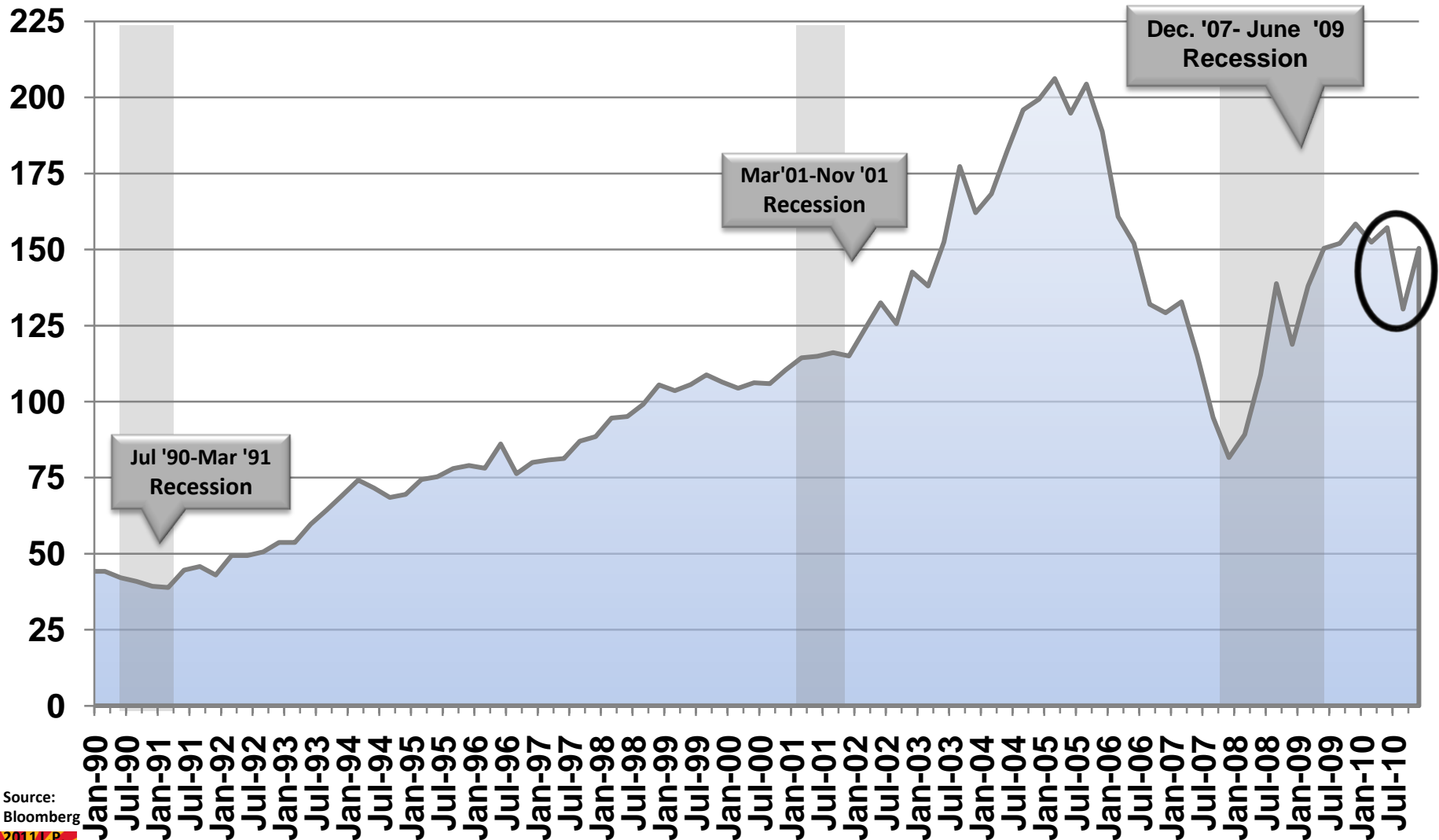


Source:  
Bloomberg  
2011 L.P.



# AZ SALES OF EXISTING HOMES

Quarterly Data Jan. 1990 through December 2010

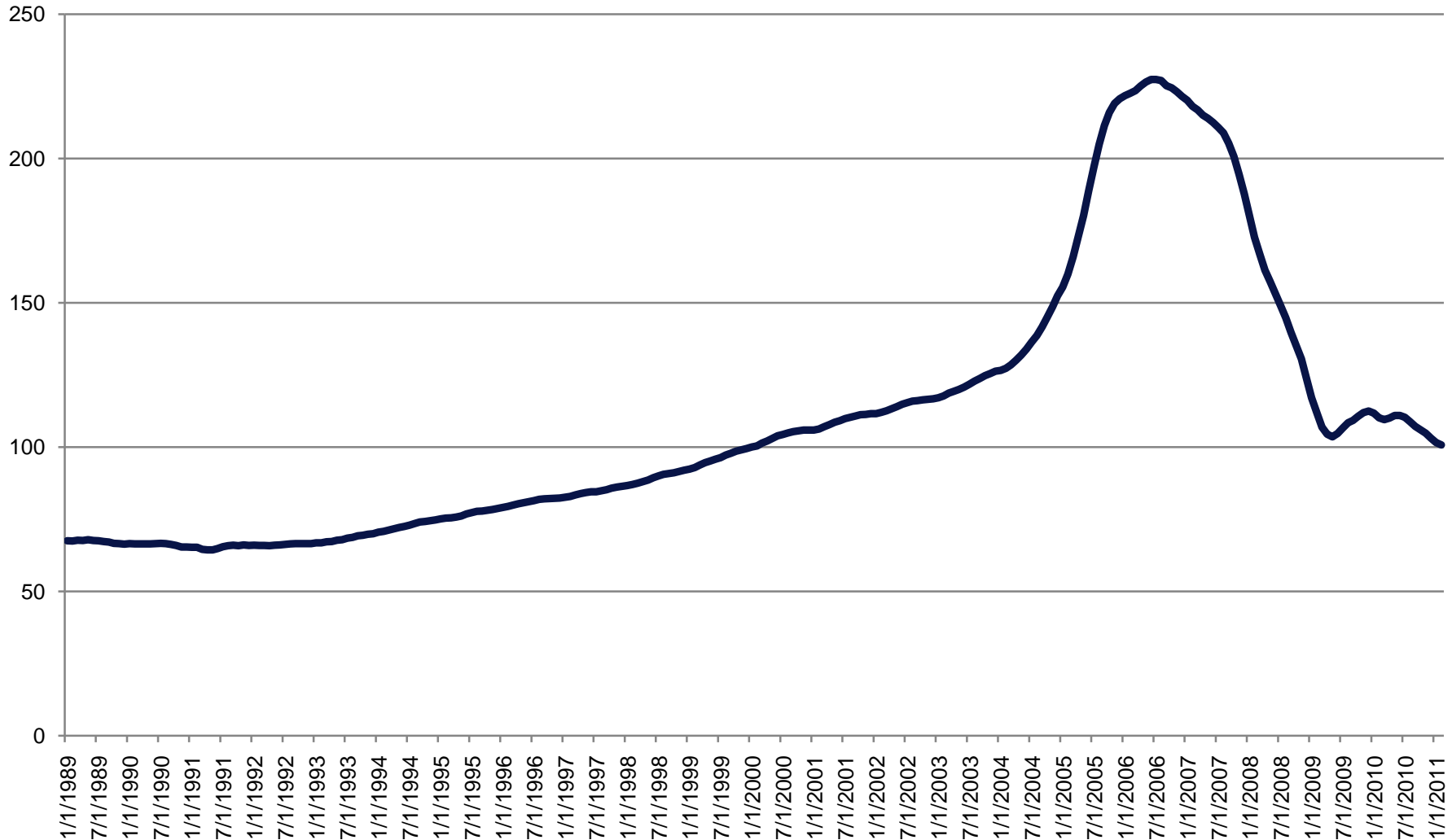


Source:  
Bloomberg  
2011 L.P.



# AZ HOUSING PRICES

## S & P/Case Schiller Housing Price Index for Phoenix



Source: Bloomberg 2011 L.P.





# Special Presentation

## Richard Stavneak, Staff Director of the Arizona Joint Legislative Budget Committee

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# **State Treasurer's Quarterly Meeting**

## **Revenue and Budget Update**

**May 5, 2011**

**JLBC**

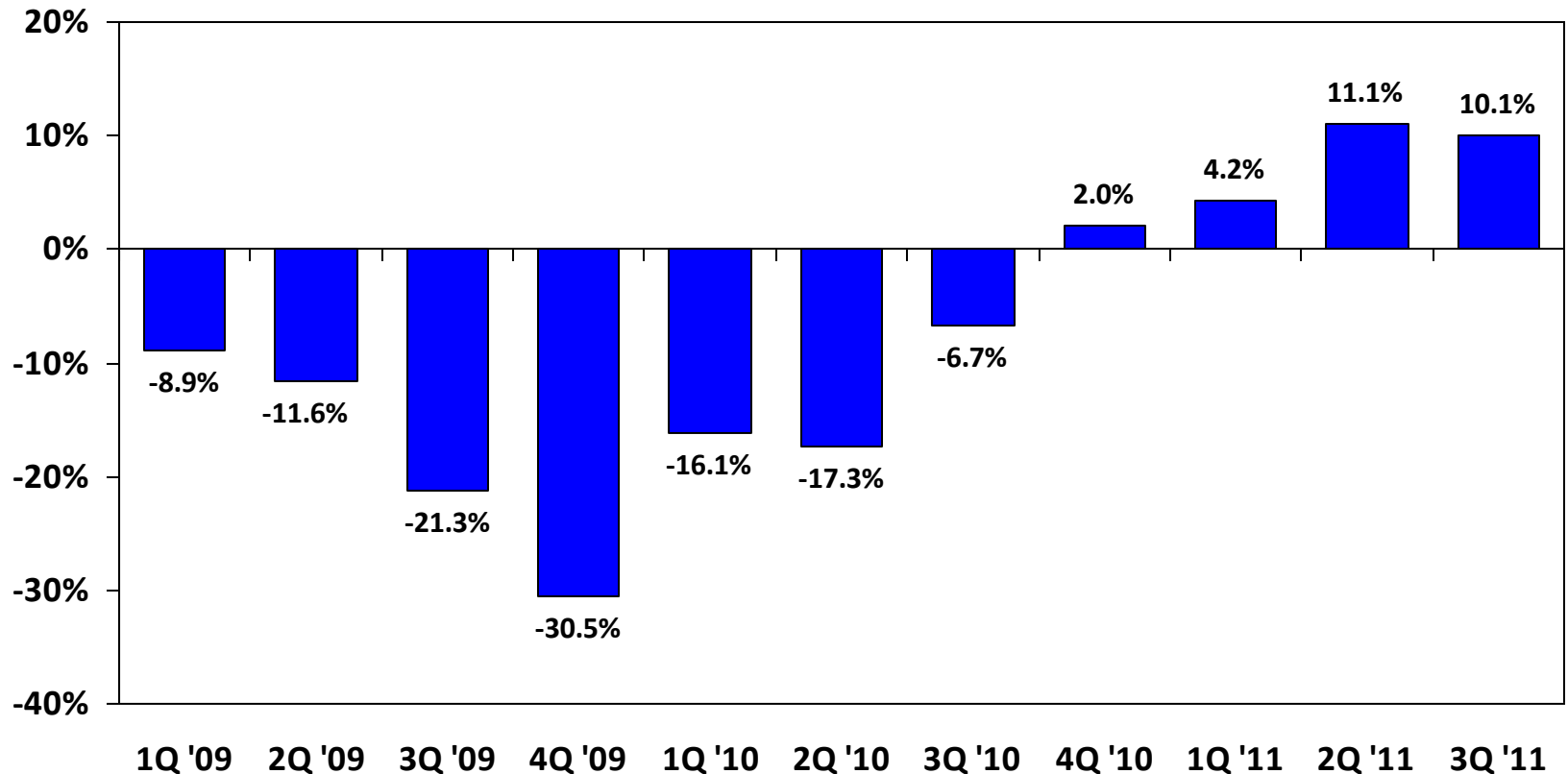
# Summary of the Current Budget Status

## Improving, but Long Term Problems Remain

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- ❑ Since bottoming out in the winter of 2010, General Fund revenues continue to recover. The end of March marked the 4<sup>th</sup> consecutive quarter of growth.
- ❑ Prospects for rapid recovery are mixed:
  - Retail sales increased by 7.3% in the last 3 months and corporate profits have been strong throughout the year.
  - We have reduced foreclosure inventory by one-third – but 35,000 still remain.
  - We are still 319,000 jobs short of the 2007 peak and any construction rebound is more than a year away.
- ❑ New FY '12 4-sector consensus growth rate of 4.2% is considerably less than budgeted rate of 5.7%.
  - One sector projects a (1.1)% decline in FY '12. Without that “double dip” recession scenario, forecast would have been 6.0%.
- ❑ In enacted FY '12 budget, permanent revenues exceed permanent spending – but structural gap reappears once 1 cent sales tax is eliminated in FY 14.

# Arizona Just Finished 4<sup>th</sup> Consecutive Quarter of General Fund Revenue Growth



# Revenue Update - Base Growth of 8.2% Through March

## - May Not Be Sustainable for Entire Fiscal Year

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	YTD '11 Over '10	
	<u>Dec</u>	<u>March</u>
Sales*	-0.6%	1.8%
Individual Income	9.7%	13.0%
Corporate Income	115.4%	54.8%

\* Without 1 Cent

- ❑ Unusually low '10 collections and higher business profits boosted corporate %.
- ❑ Individual Income Tax artificially high due to withholding change.
- ❑ After negative summer, sales tax collections have turned positive.
- ❑ Revenues \$108 M above January baseline forecast through March 2011.

## Recently Enacted Budget Incorporated Some of the Year to Date Revenue Gain

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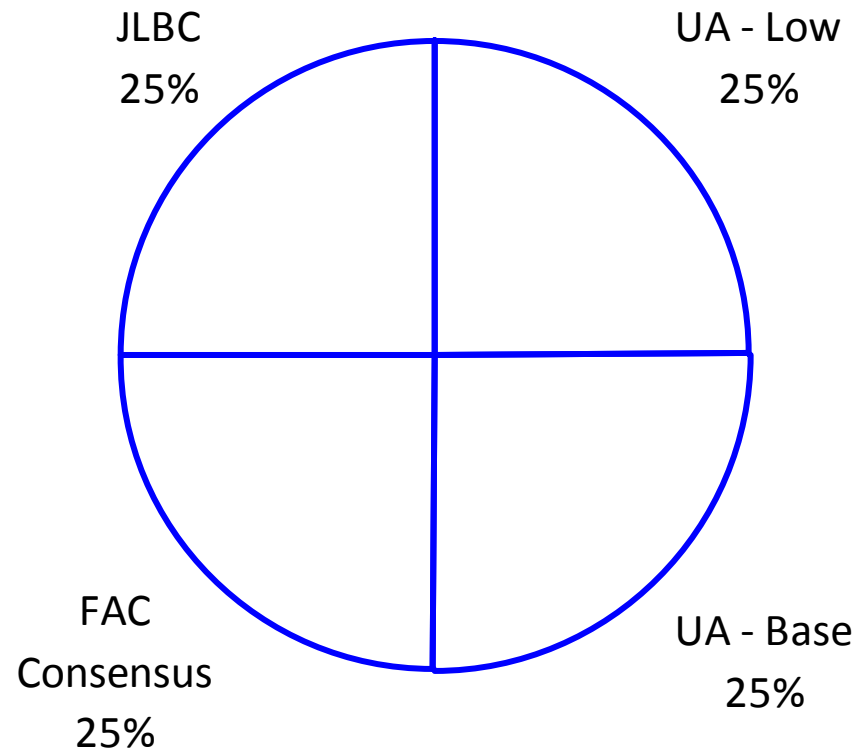
- ❑ Of the \$108 M revenue surplus, \$72 M due to Individual Income Tax
- ❑ Due to possibility of overwithholding, the approved budget included only \$40 M of the \$108 M overage

# Where Are We Headed Over the Next Few Years?

## - Four-Sector Consensus Forecast Incorporates Different Economics Views, Including the FAC

4-sector forecast equally weights:

- ☐ FAC average
- ☐ UofA model – base
- ☐ UofA model – low
- ☐ JLBC Staff forecast
- ☐ Remaining revenues (10% of total) are staff forecast



\* Includes Big 3 categories of sales tax,  
individual income and corporate income taxes



# Forecasting Constraints In the Next 15 Months

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- ❑ While revenue recovery has begun, it is difficult to forecast its speed
- ❑ Current forecasts are most useful in determining the direction of the economy, not its precise landing point
- ❑ Certain structural factors limit potential for rapid growth

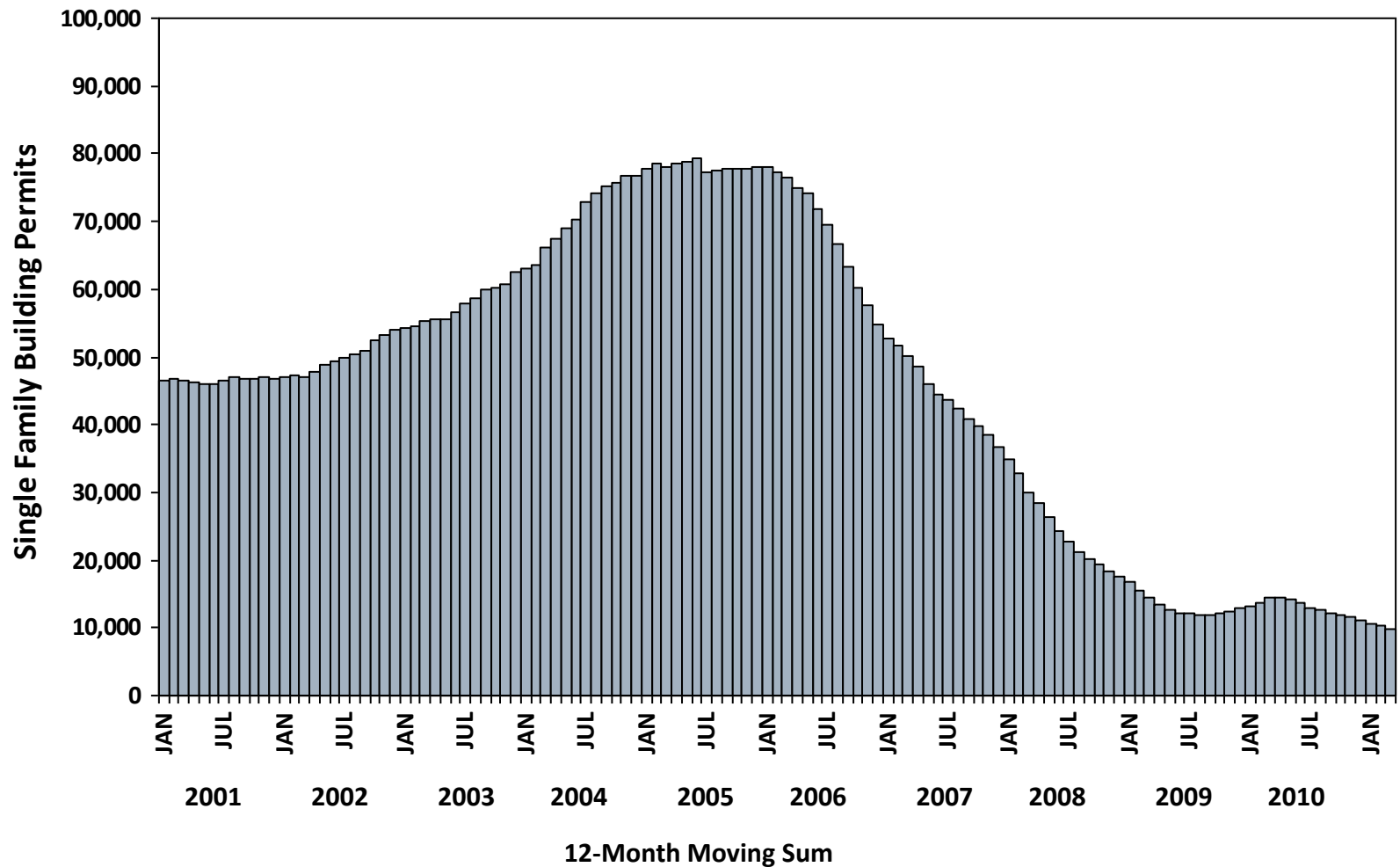
# The Road to Recovery Will Still Be Long

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	Highpoint	Now
Jobs Lost Since December 2007	398,800 (July 2010)	319,000
Pending Foreclosures	51,500 (Dec. 2010)	35,500
Mortgages Underwater	51.3% (Q4, 2009)	50.9%

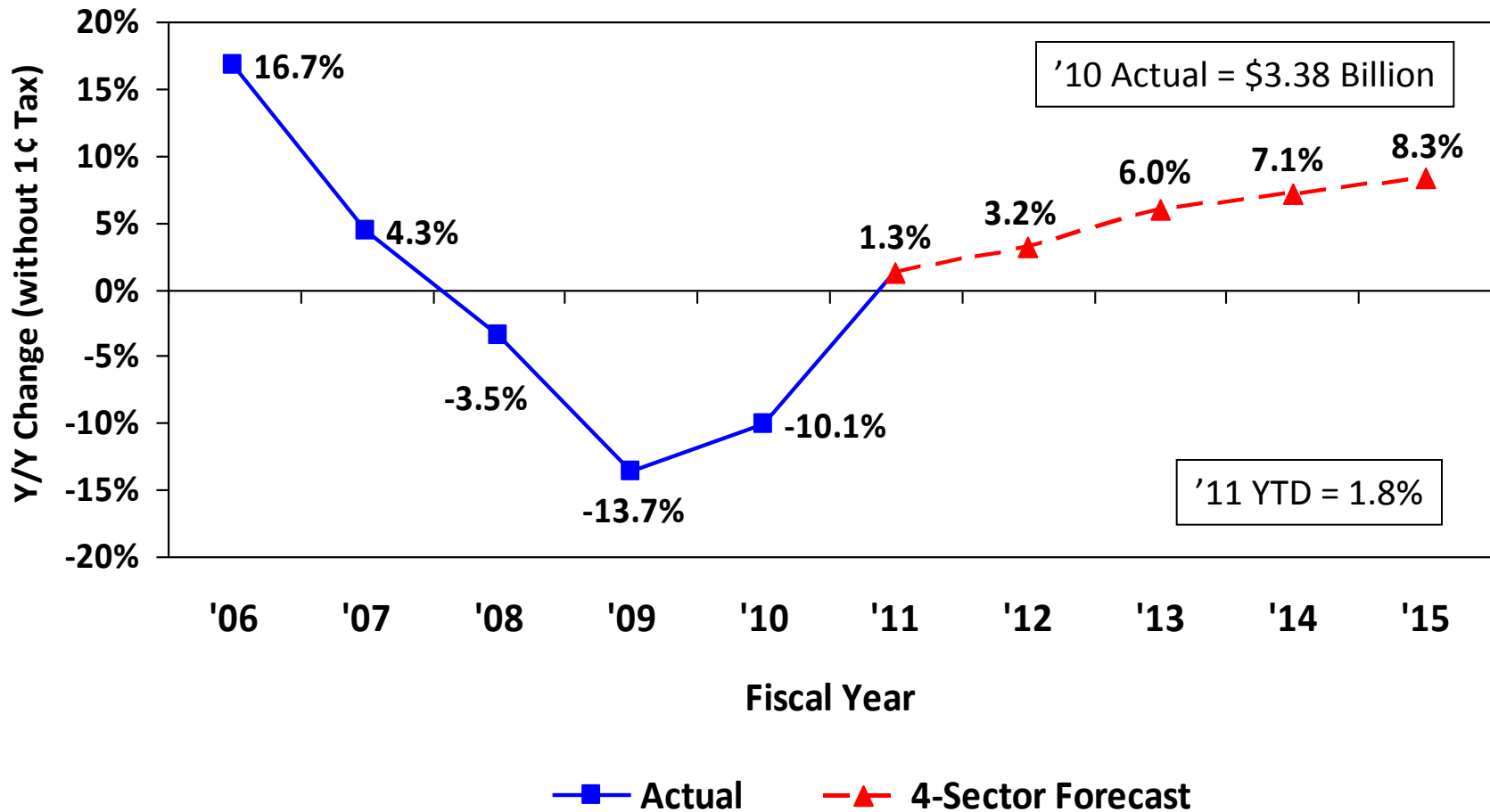
# Single Family Permits Suggest Construction Recovery Not Imminent

- 40k to 50k Annual Permits Would Reflect Healthy Economy

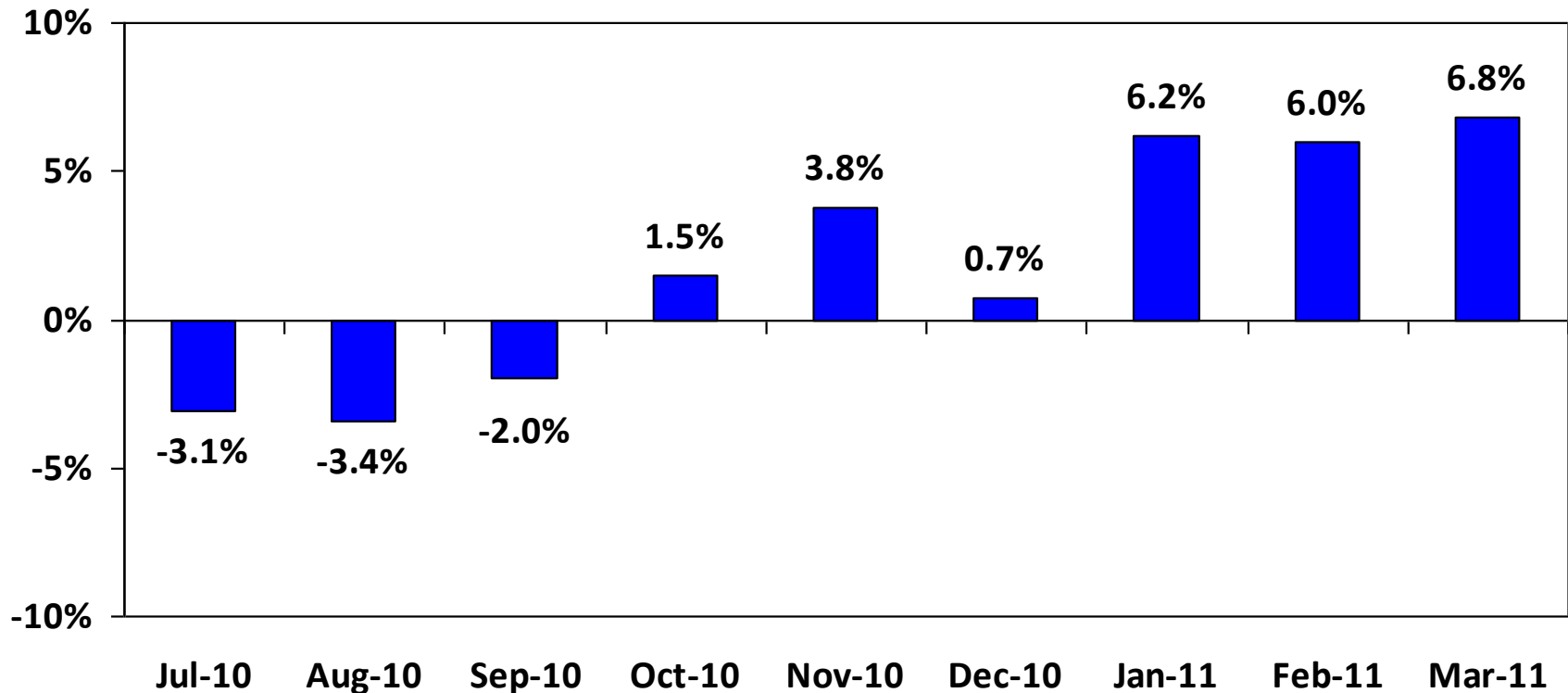


# Sales Tax

- The Consensus Forecasts Growth of 1.3% in FY '11 and 3.2% in FY '12



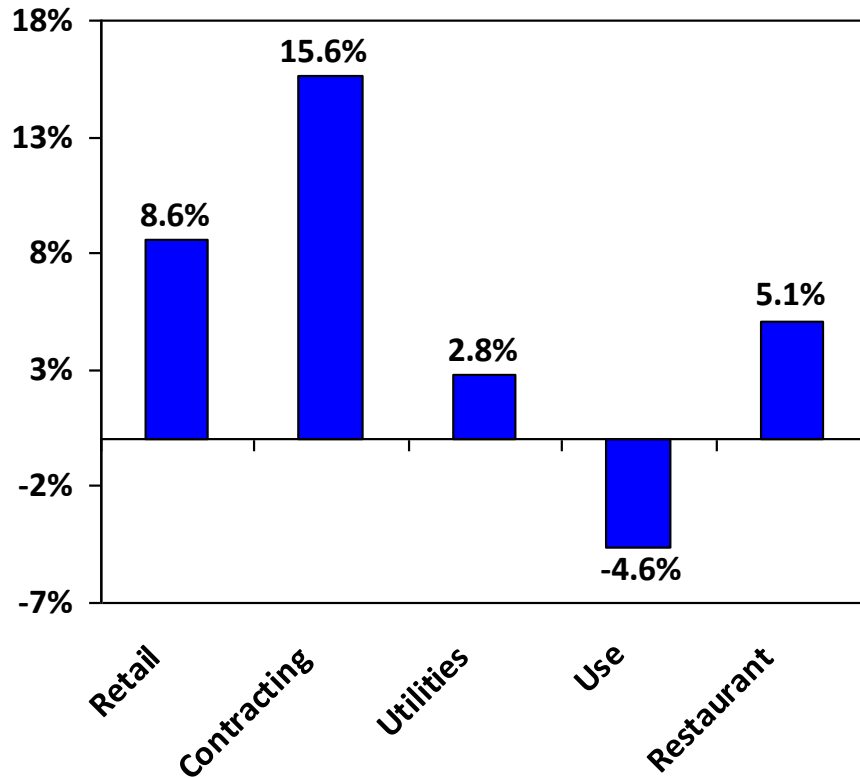
# While Sales Tax Collections Are 1.8% Year to Date, Recent Months Have Been Higher



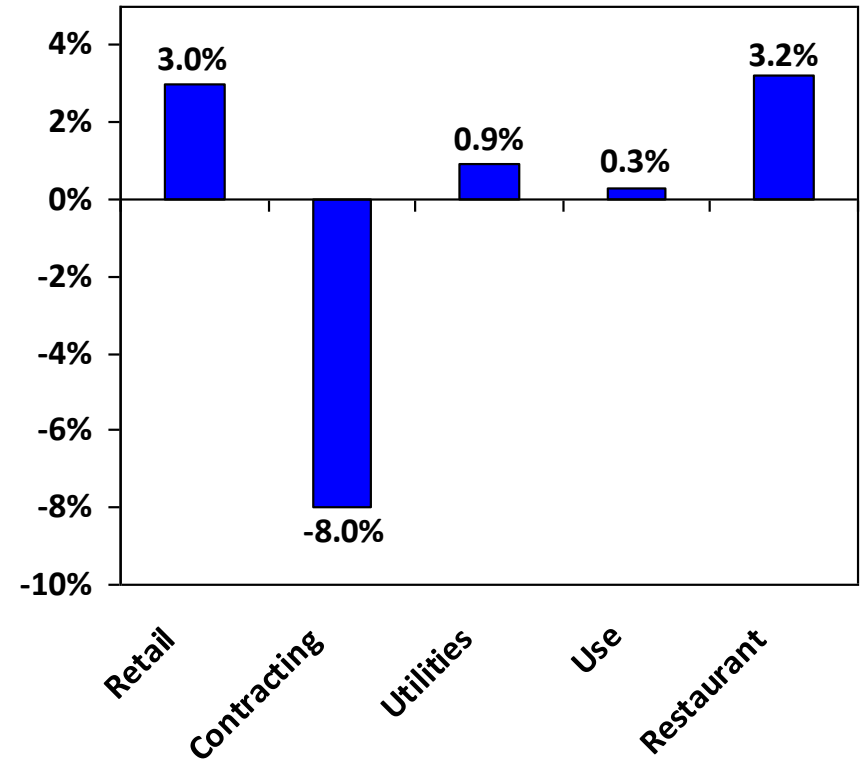
% Growth in Sales Tax Compared to Prior Year, Without 1¢ Tax

# Sales Tax Collections by Category

March Sales Tax Growth

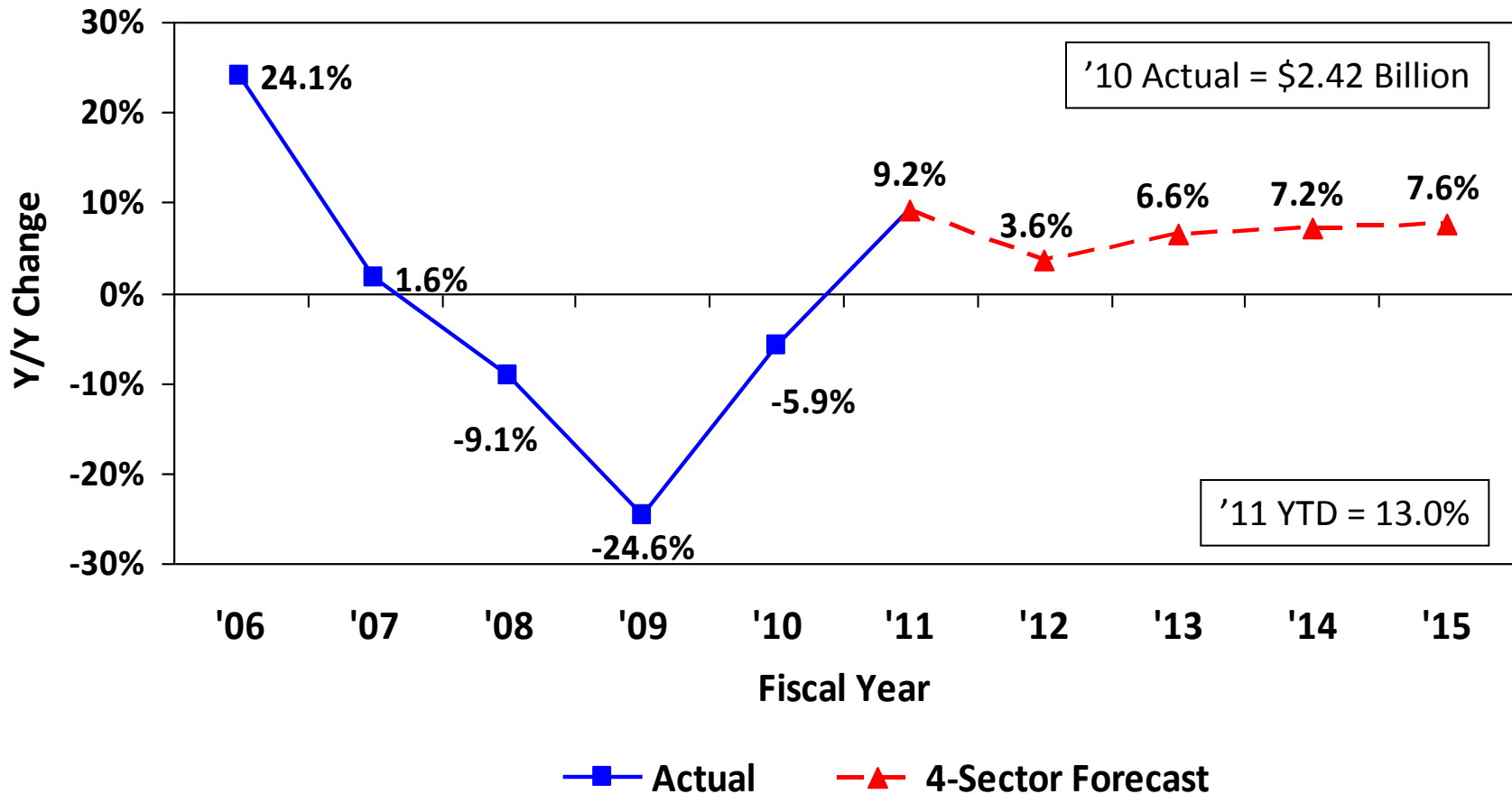


YTD Sales Tax Growth



# Individual Income Tax

- The Consensus Forecasts Growth of 9.2% in FY '11 and 3.6% in FY '12



Percentage Changes Are Prior To Tax Law Changes

Without tax law changes, growth would have been 6.3% in FY '07 and (4.1)% in FY '08

# Individual Income Tax Issues

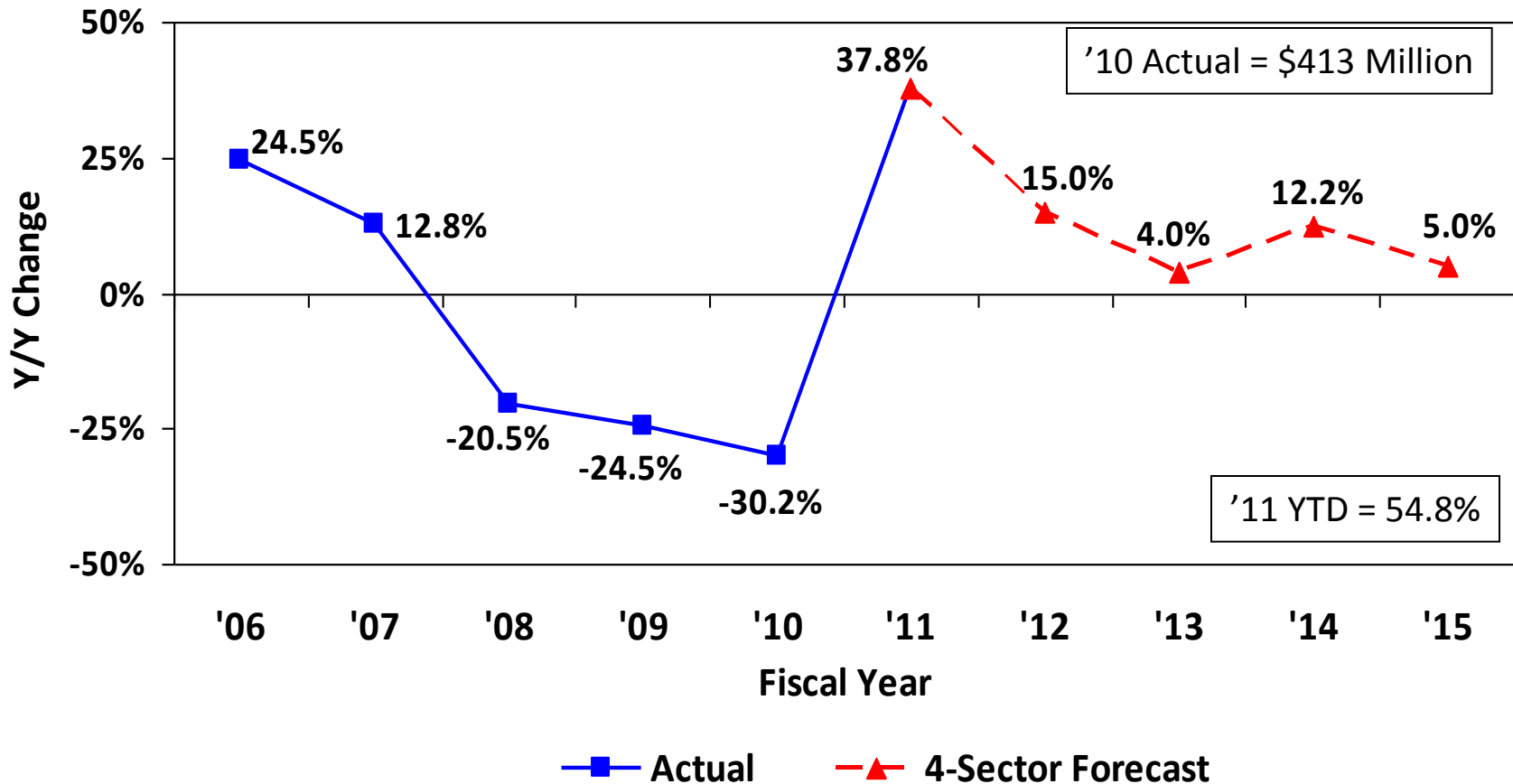
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- ❑ 5.9% year to date withholding growth is stronger than expected
  - Far outpaces nominal job and salary growth
  - Due to July withholding table changes?
  - Or, is job data again lagging reality?
  
- ❑ At same time, however, refunds have declined to date
  - Processing issue?
  - Improved small business profitability?
  - Refunds usually decline in improving economy – may mask overwithholding



# Corporate Income Tax

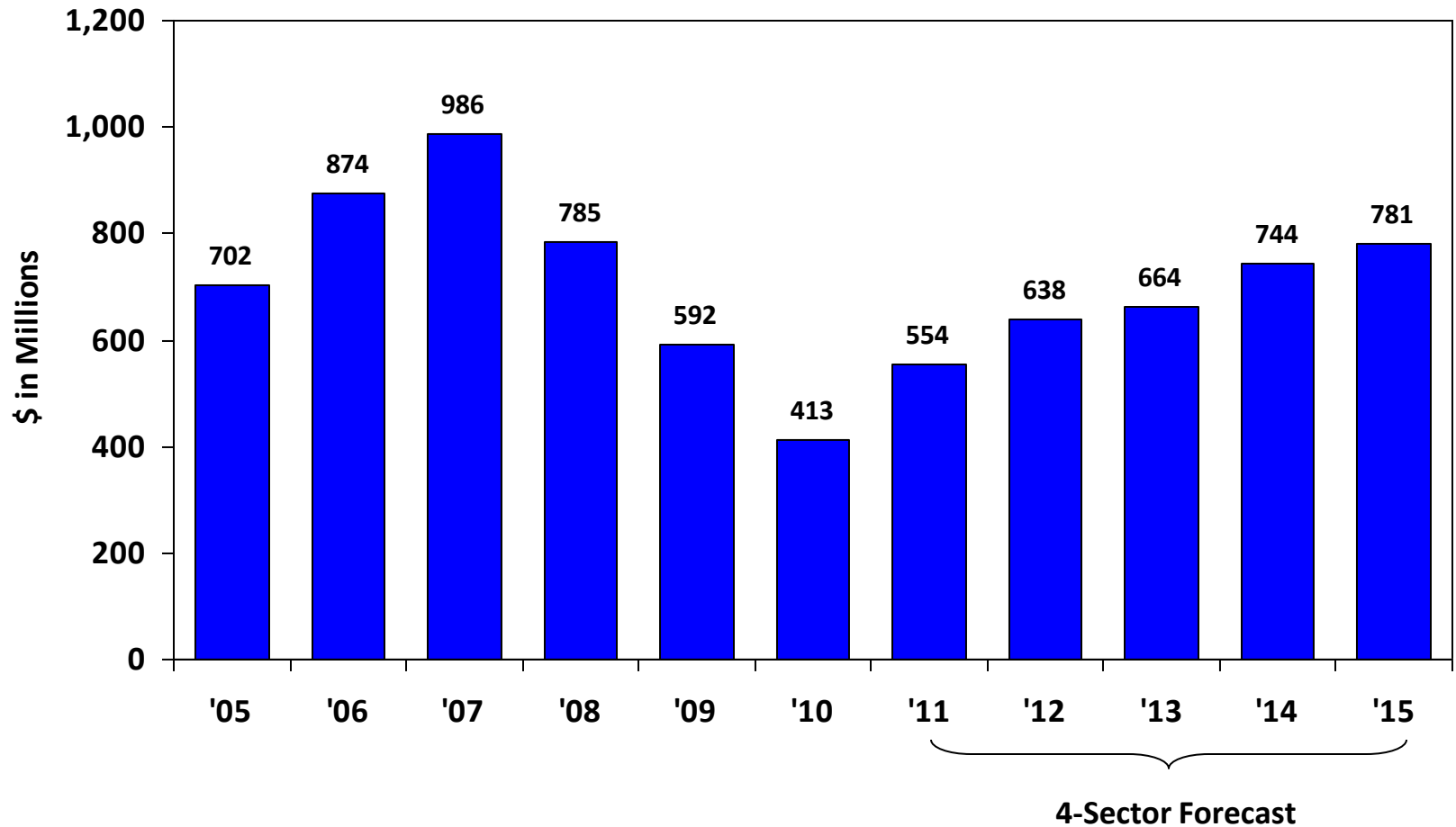
- The Consensus Forecasts Growth of 37.8% in FY '11 and 15.0% in FY '12



Percentage Changes Are Prior To Tax Law Changes

# Corporate Income Tax

- Forecast Remains Substantially Below FY '07 High Point



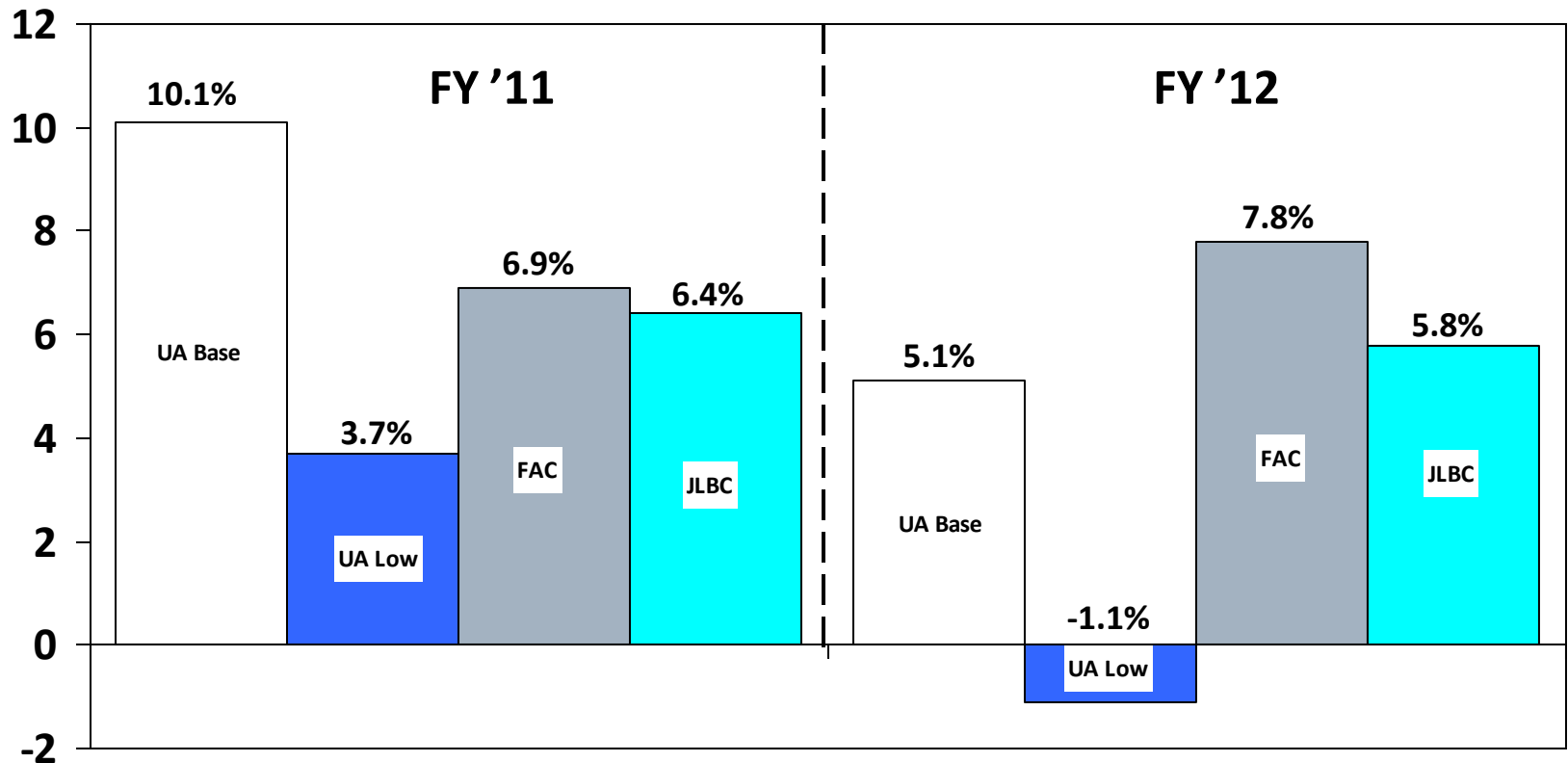
Includes enacted tax law changes.

# Corporate Income Tax Could Experience Large % Gain in FY '11

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- ❑ Net collections were up by 115% through December.
- ❑ FY '10 corporate refunds were inflated by extraordinarily large returns in November 2009.
- ❑ In FY '10, collections declined by (63)% in the 1<sup>st</sup> half of year compared to an increase of 5% in the 2<sup>nd</sup> half – as a result, expect lower % growth for rest of FY '11.
- ❑ Update: In January through March, corporate collections declined relative to FY '10. As a result, YTD growth down to 55% through March.

# Consensus Predicts Growth of 5.6% in FY '11 and 4.2% in FY '12\*



Details in Appendix A

\* Weighted Big 3 average growth prior to 1 ¢ sales tax is 6.4% in FY '11 and 4.3% in FY '12. After adjusting for small tax categories, the base growth rate is 5.6% in FY '11 and 4.2% in FY '12.

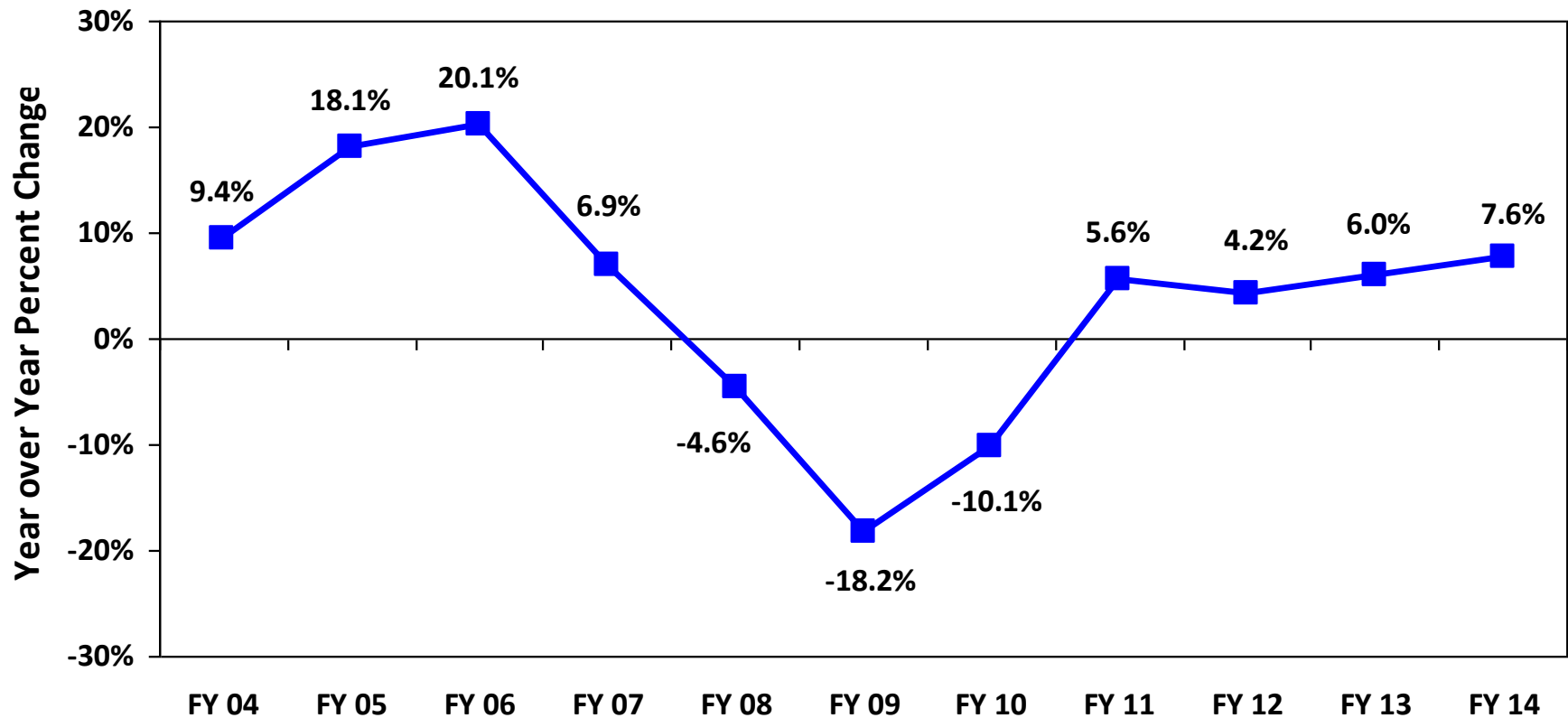
# Comparison of Consensus Forecast and March Budget

- March Budget Assumed 5.7% Base Growth in Both FY '11 and '12

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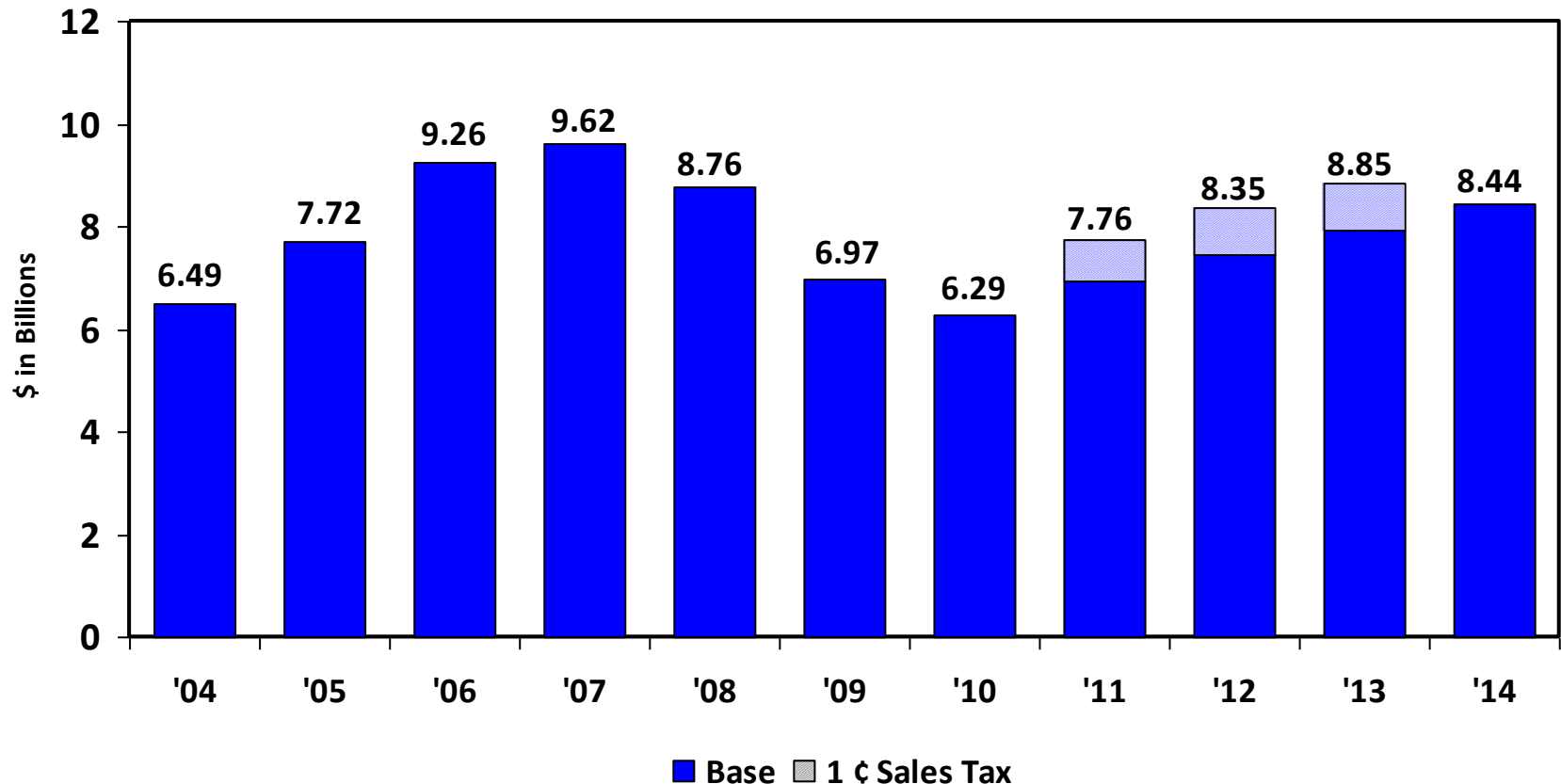
- ❑ The April consensus is 0.1% less than the FY '11 March budgeted rate
  
- ❑ At 4.2%, the FY '12 consensus rate is considerably lower than the FY '12 budgeted rate
  - Without UA Low forecast of (1.1)% decline, the Consensus rate would have been 6.0%
  - A revenue decline would represent a “double dip” recession

# Consensus Forecasts Higher Base Revenue Growth Rate in Both FY '13 and FY '14



- To reflect underlying economic growth, "Base" revenues exclude balance forward, tax law changes, one-time revenues, and urban revenue sharing

# Consensus Forecasts Still Below FY '07 Level



FY 12 represents budgeted revenue level.

Excludes balance forward and other one-time revenues. Includes tax law changes and Urban Revenue Sharing.

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# **Summary of Enacted Budget Impacts**



# Impact of Enacted Budget

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- ❑ The projected FY '11 baseline shortfall was \$(543) M
  - The budget addressed this issue with \$211 M of spending reductions, fund transfers, and base revenue adjustments
  - The remaining \$332 M shortfall will be resolved in FY '12
  
- ❑ The projected FY '12 shortfall was \$1.48 B, including the \$332 M FY '11 shortfall
  - The budget primarily addressed this shortfall with \$1.14 B in net spending reductions

# The FY '11 and FY '12 Budget Solutions

\$ in Millions

	<u>FY 11</u>	<u>FY 12</u>
<input type="checkbox"/> Baseline Shortfall	\$(543)	\$(1,152)
• Unresolved '11 Shortfall	--	<u>(332)</u>
• Total Shortfall	(543)	(1,484)
<input type="checkbox"/> Solutions		
• Spending Reductions	121	1,143
• Fund Transfers	50	167
• Added Base Revenue	40	70
• Other Revenue	--	43
• New Local MVD/DPS/Cash Payments	--	<u>66</u>
Total Solutions	211	1,489
<input type="checkbox"/> Revised Surplus/Shortfall	\$(332)	\$5

# Despite \$1.1 B in Reductions, Overall Spending Levels Remain Near \$8.3 B

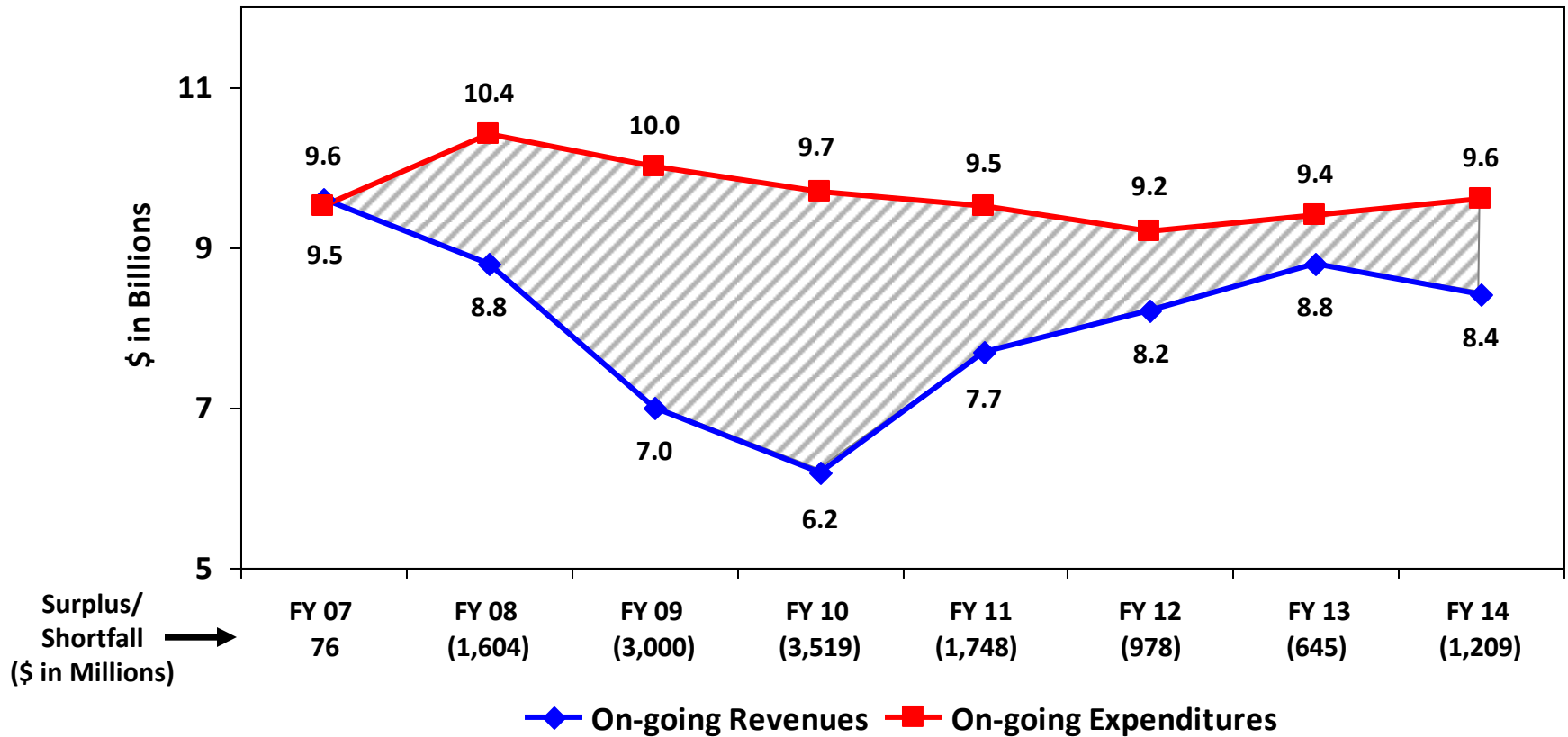
- Backfill of Federal Stimulus Funds Offsets Reductions

	\$ in Millions		
	<u>Backfill/Caseload</u>	<u>Net Reductions</u>	<u>Net Change</u>
Department of Education	\$143	\$(163)	\$(20)
AHCCCS	499	(511)	(12)
Department of Corrections	(7)	10	3
Universities	0	(198)	(198)
DES	64	(50)	14
DHS	155	(97)	58
SFB	97	0	97
One Extra Payroll	79	0	79
Employee Benefit Savings	<u>0</u>	<u>(62)</u>	<u>(62)</u>
Total	\$1,030	\$1,071	\$(41)

# In January, the FY 12 Structural Gap was \$(1.0) B

## - Represents On-Going Revenues Versus Ongoing Expenditures

"The Structural Shortfall"

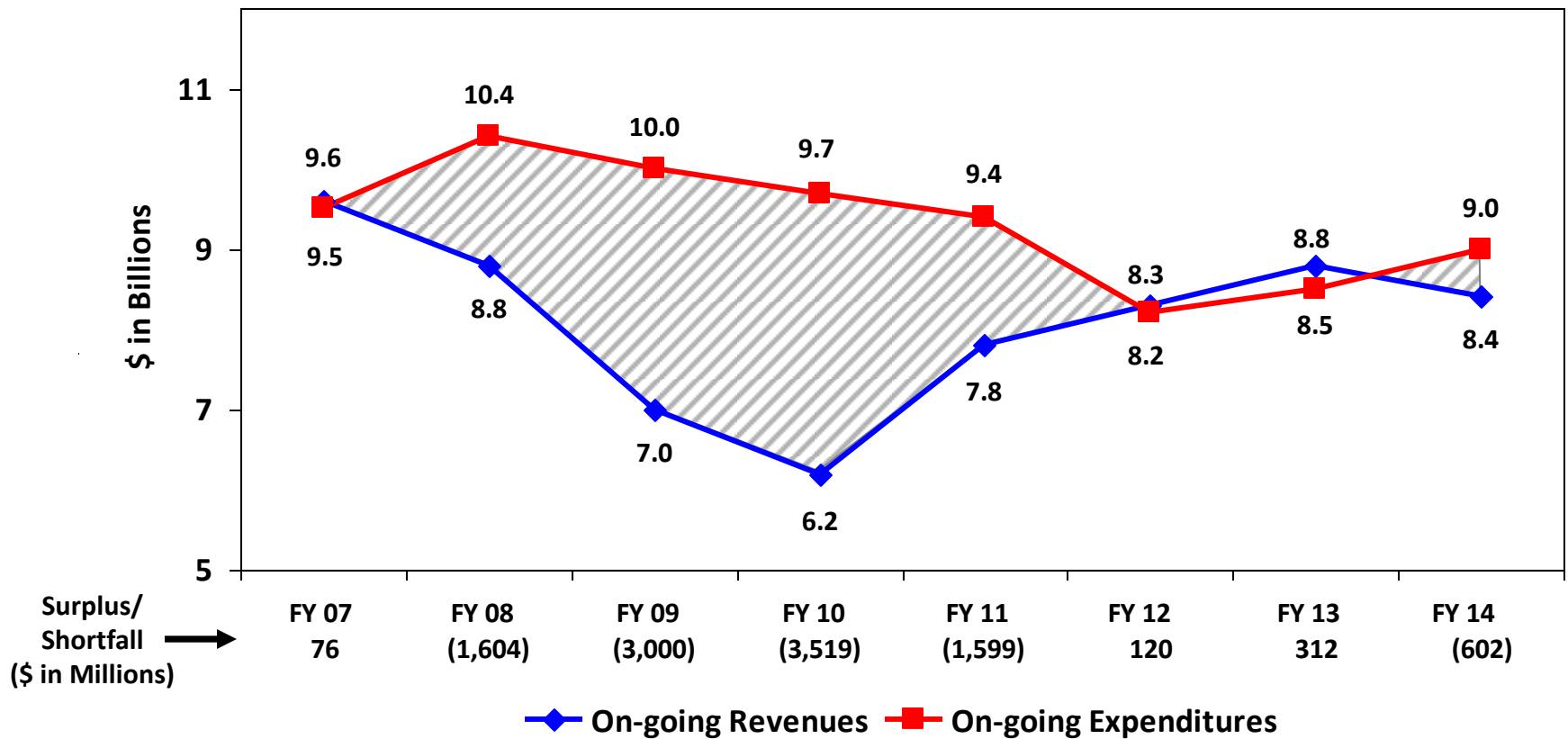


Counts 1 ¢ TPT as on-going in FY '12 – FY '14

# With the Newly Enacted Budget, the Structural Gap Has Been Eliminated Through FY '13

- Gap Reappears in FY '14 with Lapse of 1¢ Sales Tax

"The Structural Shortfall"



Counts 1 ¢ TPT as on-going in FY '12 – FY '14

# Structural Gap Does Not Include Inactive Formulas

- Including These Formulas, the “Shadow Shortfall” in FY ’14 is \$1.6 B

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- ❑ JLBC Baseline estimates assume the continuation of current statutory suspensions
- ❑ In January, inactive formulas were estimated at \$1.3 B
- ❑ Current estimate of statutory suspensions is \$1.0 B (see Appendix B)
  - Budget reduced this amount by making some past reductions permanent
  - However, some new solutions were formula suspensions

# Appendix A: March 2011 4-Sector Forecast

	FY 2011	FY 2012	FY 2013	FY 2014
<b>Sales Tax</b>				
JLBC Forecast	2.8%	5.5%	6.7%	7.1%
UA – Low	-1.6%	-1.8%	5.1%	7.6%
UA – Base	1.5%	3.1%	6.6%	7.7%
FAC	2.3%	6.1%	5.6%	5.9%
Average:	<b>1.3%</b>	<b>3.2%</b>	<b>6.0%</b>	<b>7.1%</b>

## Individual Income Tax

JLBC Forecast	6.7%	6.4%	6.8%	7.0%
UA - Low	6.7%	-5.2%	6.1%	8.1%
UA – Base	15.7%	6.1%	7.1%	7.4%
FAC	7.8%	7.2%	6.4%	6.4%
Average:	<b>9.2%</b>	<b>3.6%</b>	<b>6.6%</b>	<b>7.2%</b>

## Corporate Income Tax

JLBC Forecast	34.5%	4.8%	2.9%	7.8%
UA – Low	29.3%	22.7%	-1.1%	8.6%
UA – Base	48.3%	11.6%	2.2%	24.9%
FAC	39.2%	20.9%	12.0%	7.7%
Average:	<b>37.8%</b>	<b>15.0%</b>	<b>4.0%</b>	<b>12.2%</b>

JLBC Weighted Average:	<b>6.4%</b>	<b>5.8%</b>	<b>6.4%</b>	<b>7.1%</b>
UA Low Weighted Average	<b>3.7%</b>	<b>-1.1%</b>	<b>4.8%</b>	<b>7.9%</b>
UA Base Weighted Average	<b>10.1%</b>	<b>5.1%</b>	<b>6.4%</b>	<b>9.1%</b>
FAC Weighted Average:	<b>6.9%</b>	<b>7.8%</b>	<b>6.5%</b>	<b>6.3%</b>
Consensus Weighted Average:	<b>5.6%*</b>	<b>4.2%*</b>	<b>6.0%</b>	<b>7.6%</b>

\* Consensus forecast adjusted for small revenue categories

# Appendix B: Funding Formula Suspensions

## Statutory Funding Formula Suspensions\*

<u>Agency</u>	<u>Formula</u>	<u>FY 2012 Formula Requirement</u> <u>BASELINE</u>	<u>FY 2012 Formula Requirement</u> <u>ENACTED</u>
Community College	Capital State Aid Suspension	\$22,155,200	\$22,155,200
Department of Education	Soft-Capital Formula	\$165,120,700	\$188,120,700
	New Utilities Formula	\$100,000,000	\$0
	Charter School Additional Assistance	\$10,000,000	\$17,656,000
	Capital Outlay Revenue Limit (CORL)	-	\$63,684,600
	CORL – EduJobs	-	\$35,000,000
	Fund JTEDs at 91%	\$4,849,100	\$4,849,100
Department of Emergency & Military Affairs	Military Installation Fund Deposit	\$2,800,000	\$0
	Governor’s Emergency Fund	\$1,100,000	\$1,100,000
Department of Environmental Quality	WQARF	\$8,000,000	\$8,000,000
Department of Health Services	Restoration to Competency	\$1,740,600	\$1,740,600
	SVP	\$2,670,300	\$2,670,300
Judiciary	Probation Revocation Payment	\$2,410,300	\$0
School Facilities Board	Building Renewal	\$241,593,600	\$241,593,600
Tourism	Tourism Funding Formula	\$14,350,100	\$14,350,100
State Treasurer	Justice of the Peace Salaries	\$1,115,000	\$0
Universities	Financial Aid Trust	\$4,089,600	\$4,089,600
Department of Water Resources	Water Protection Fund Transfer	<u>\$5,000,000</u>	<u>\$0</u>
<b>Subtotal</b>		<b>\$586,994,500</b>	<b>\$605,009,800</b>
Future Year Cost – Department of Education	Teacher Performance Pay (by FY 2018)	\$278,000,000	\$0
Future Year Cost – School Facilities Board	New School Construction (If enrollment returns to pre-recession level)	<u>\$386,000,000</u>	<u>\$386,000,000</u>
<b>Total</b>		<b>\$1,250,994,500</b>	<b>\$991,009,800</b>
<b>Non-Statutory Formula Suspensions</b>			
Department of Administration	Building Renewal	\$38,710,500	\$27,580,000
Universities	General Fund Enrollment	\$28,432,000	\$28,432,000
	Building Renewal	<u>\$90,136,900</u>	<u>\$90,136,900</u>
<b>Subtotal</b>		<b>\$157,279,400</b>	<b>\$146,148,900</b>

\* Excludes AHCCCS suspensions which are accounted for in the Baseline.





# QUESTIONS?

OFFICE OF THE ARIZONA STATE TREASURER

